The New York Certified Public Accountant

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Fiduciary Accounting

Federal Estate Taxation

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NEW YORK STATE TAX CLINIC

THE SHOPTALKERS

OFFICIAL DECISIONS AND RELEASES

BOOK REVIEWS

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Objects of the Society

"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public, to protect the interest of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects, and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

—From the Certificate of Incorporation.

The New York Certified Public Accountant

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The Shoptalkers

Conducted by Lewis Gluick, C.P.A.

It being just about the hottest Wednesday of the summer, Oldtimer and Philo found themselves alone at the club table. "I'm glad this happened," said the latter, "for I wanted to get your opinion on something."

"And," said Oldtimer with an amused but benign smile, "having already committed yourself, you did not desire to have others hear me disagree with you."

"You're psychic!" said Philo. "And here's the problem: It all started when Law had clients come to him *after* they had put through a deal . . ."

"Typical," interrupted Oldtimer.

". . . and he thought there was an accounting angle, so he called me."

"Well, at least there's one barrister who is all right," said Oldtimer. "We are obliged to learn a lot of commercial law to get our certificates, but the Bar doesn't require even a smattering of bookkeeping on its examinations. Law got his wisdom the hard way, but he got it—more power to him!" Both C.P.A's. raised their iced-tea glasses and solemnly toasted Law. Then Philo resumed.

"As is so common, the problem was not essentially a tax problem. Once the accounts were correctly set up, the taxes took care of themselves."

Lewis Gluick, C.P.A., who has been a member of our Society since 1924, has resumed the practice of accountancy in the East.

Mr. Gluick, who had been writing under the name of The Shoptalker in other magazines since 1928, recently brought his group of Shoptalkers to our columns. We would welcome your acceptance of his invitation to participate in the discussions.

"Aren't you getting the dividend paid before it's declared?" queried Oldtimer. "*What* was the problem?"

"Well, it seems that about ten years ago Walter and Zachary went into business. They formed the Wezee Corporation, and each took 250 of the 1,000 authorized shares, paying par, $100. They prospered from the start, and in a year, to get more working capital for expansion, they took in Xavier, making him pay book value, $105, for each of his 250 shares. A year later they took in Yerkes for the rest of the shares; only by that time the surplus had gone up, and Yerkes paid $110 per share. After that they just went ahead and made Wezees and profits.

A few weeks ago Walter and Yerkes wanted to get out. The big argument was about dividends. The Corporation had acquired some realty, never used for expansion, but held to protect itself if needed. Its value had enhanced enormously, and . . . well, see for yourself." And Philo handed over this Balance Sheet:

Cash	$ 100,000
All other current assets	400,000
Plant and equipment (net of depreciation)	500,000
Unimproved realty (cost, $60,000) appraised at	300,000
Total Assets	$1,300,000
All Liabilities	200,000
Net Worth	$1,100,000
Consisting of:	
Capital Stock	$ 100,000
Surplus Paid In	3,750
Surplus from Appreciation	240,000
Surplus Earned	756,250
	$1,100,000

"Walter and Yerkes wanted to sell the land and cut a melon. The others balked for reasons not all of which were high taxes. So they cooked up a deal.

(Continued on page 598)

The Shoptalkers

(Continued from page 596)

Walter and Yerkes would sell their stock to the corporation at *book value*. Since that was $550,000 and the earned surplus alone was greater than that, that was legal. They would take the realty at *appraised value* as a down payment, and five-year interest bearing notes (secured by a mortgage on the plant) for the remainder of the price. It was, manifestly, an arm's length deal, if I ever saw one. And that's where Law came in, to draw up the minutes, deeds, etc. But he smelled tax trouble, and called me."

"It's a good thing you ordered a cold salad plate," said Oldtimer. "Any hot dish would be chilled by now, after that exposition. Now *you* eat while I answer the questions you have in mind."

"In the first place, set up the Treasury shares. First take Walter's. He paid par. So you don't touch Paid-In Surplus for them. You do remove $10 per share for Yerkes' 250 shares. Now if you set up the Treasury Stock at cost, and that is indubitably $550,000, Surplus will not be reduced, else the balance would be upset. Yet, if Wezee Corporation resells any or all of the shares, the cost must be known and recorded. The corporation would be taxed on a gain, and establishment of a high cost is helpful."

Philo, mouth full of lettuce, nodded vigorous assent. Oldtimer backed the balance sheet with the menu, took out his pencil and, in a few minutes, produced this:

Current and Fixed Assets		$1,000,000
Current Liabilities	$200,000	
Notes Secured by Plant	250,000	450,000
Net Worth		$ 550,000
As follows:		
Capital Stock: 1,000 shares @ par		$ 100,000
Less in Treasury: 500 shares @ par		50,000*
Outstanding: 500 shares @ par		$ 50,000
Paid in Surplus	$ 1,250	
Earned Surplus	498,750	500,000
		$ 550,000

* Cost to Corporation.

"That may not be perfect S.E.C. form, but it does provide full disclosure, without inflation of net worth."

Philo grinned from ear to ear. "Just the way I did it! And the Wezee corporation has undoubtedly derived a taxable, capital gain of $240,000, so the balance sheet must be amended to show the tax liability thereon."

"The Commissioner will give you an argument on that *capital* gain," replied Oldtimer. "But I think you and Law can beat him. Trouble is the deal was consummated too quickly, and if the Company is stuck, it's just too bad."

"How about the sellers?" said Philo. "They've got a whopping tax to pay, even @ 25%. But I wish *I* could have gotten into a deal as profitable as they did when they bought into the company."

"Too bad," said Oldtimer, "that the Shoptalker isn't here to report this. He'd get some of his constant readers to take issue with us."

"I'll send it to him," said Philo.

And he did. Dissenting opinions are invited. Please omit any mention of Section 102. Philo says that's out of the picture.

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THE NEW YORK
CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

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A Note on the History of Fiduciary Accounting in New York

By ORRIN R. JUDD, C.P.A.

ORRIN R. JUDD, C.P.A., has been a member of the Society since 1903 and has served for several years on the technical Committee on Fiduciary Accounting. He was graduated from the School of Commerce, Accounts and Finance of New York University, with the degree of B.C.S., in its first class, in 1902, and from the School of Law, with the degree of LL.B. in 1904. He was also admitted to the New York Bar in 1904. For six years he lectured on Banking Practice in the School of Commerce.

His public practice has been mainly in the field of banking, institutional and fiduciary accounting. He served in the Trust Departments of the Knickerbocker, Columbia and Irving Trust Companies, retiring as a Vice-President of the latter in 1933. Since 1933 he has been connected with The Kings County Savings Bank of Brooklyn, of which he is now Vice-President.

He is Secretary of the Council of New York University. He is a member of the Advisory Board of the School of Accountancy and Business Administration of Pace College.

This paper was presented at a technical meeting of the Society held at the Engineering Societies' Building on May 12, 1949, under the auspices of the Committee on Fiduciary Accounting.

As a preliminary to the discussion of court settlement of the accounts of fiduciaries it may be interesting to review briefly the steps by which the courts have come to exercise authority over fiduciaries.

Fiduciaries

A fiduciary, in law, is a person who holds property in trust, as an attorney, a guardian, an executor, or a trustee. When a person receives property not belonging to himself he is under obligation to account for it to the owner.

Ownership

The concept of ownership has existed from time immemorial, and laws made for the protection of property rights have been found by archeologists inscribed on tablets dating back to prehistoric eras.

The Law

Twenty-five hundred years ago the Roman empire had spread over the entire civilized world and Roman law had become firmly rooted in the diverse countries which made up that great empire. To the Roman scheme of justice, modified necessarily by local customs, can be traced the jurisprudence of all the nations of the western hemisphere. In our own country the common law of England, whose colonists settled most of the United States, prevails as the basis of our system of laws,

except in a few States where the law still reflects the principles of the codes of France or Spain, implanted by French or Spanish colonization in the seventeenth century. In these cases there is a closer resemblance to the Roman law (also called the Civil Law).

Canon Law

With the decline and fall of the Roman empire and the gradual extension of Christianity throughout the world the influence of the church gained the ascendancy and challenged the supremacy of the civil law. Eventually the church's canon law attained exclusive jurisdiction in matrimonial, testamentary and criminal causes. Canon law still formed a fundamental division of the judicial power in England but the extent of its jurisdiction was restricted by legislation from time to time and, in 1857, was very materially diminished by the establishment of courts of probate and of divorce and matrimonial causes. Our own surrogates' courts are a lineal descendant of the English ecclesiastical courts.

The Common Law

The common law is a body of legal decisions and precedents. It is contrasted with statute law, promulgated by the sovereign power, and with equity, which has been described as the law prevailing between man and man. The King's courts in England were vested with power to determine controversies under the unwritten common law and the statutes of the realm. The fairness and justice of their decisions were frequently called in question because, unmodified by the circumstances of the particular case, they were alleged to be unduly harsh. Complaints came to be addressed to the King, in whom was believed to reside a residue of judicial power over and above the authority delegated to the courts, praying for relief, as of grace, that was beyond the power of the common law to afford.

Equity

These petitions were referred by the King to his Chancellor, and Courts of Chancery or equity were established for their hearing and determination. The early Chancellors were usually ecclesiastics. Cardinal Wolsey, who was the Lord High Chancellor from 1515 to 1529 in the reign of Henry VIII, said that Chancery was a court of conscience offering the people justice. The Encyclopedia Britannica, in its article on Equity, says:

> "Equitable jurisdiction is said to be *exclusive, concurrent* or *auxiliary*— Equity has *exclusive* jurisdiction where it recognizes rights which are unknown to the common law: the most important example is trusts. It has *concurrent* jurisdiction in cases where the law recognized the right but did not give adequate relief, or did not give relief without circuity of action or some similar inconvenience. And equity has *auxiliary* jurisdiction when the machinery of the courts of law is unable to procure the necessary evidence . . .
>
> "Modern equity does not profess to soften the rigor of the law or to correct the errors into which it falls by reason of its generality. It takes its principles almost wholly from recorded decisions and statutes."

Courts of law and of equity existed in England for many years side by side. They often clashed with each other in claims of jurisdiction.

The Judicature Act of 1873 consolidated the courts of law and equity, and ordered that law and equity should be administered concurrently, according to rules contained in the Act. At the same time many matters of equitable jurisdiction are still left to the chancery division of the High Court in the first instance.

Proceedings in Chancery were approached from an administrative rather than a judicial standpoint.

New York Law

The common law of England has prevailed in the State of New York since the departure of the Dutch in 1664. Equity was formerly administered by the Court of Chancery but

many years ago the Chancery court was consolidated with the Supreme Court and the same judges now decide matters both on the "law side" and the "equity side." Trusts have always been considered as within the province of equity. Testamentary trusts are under the exclusive original jurisdiction of the Surrogate's Court, which has been established to administer justice in all matters relating to the affairs of decedents, including the trial and determination of all questions, legal or equitable, necessary to make full, equitable and just disposition of any given case. The law of wills and the law of intestate succession (the Decedent Estate Law) are statutes of distribution. The general jurisdiction of the Surrogate's Court is set forth in the Surrogate's Court Act. There is a Surrogate's Court in each county of the State. Appeal may be taken from a Surrogate's Court to the Appellate Division of the Supreme Court and the Court of Appeals.

The Settlement of Accounts

Trustees under Trusts created by Agreement

Accounts of trustees under *inter vivos* trusts are under the exclusive jurisdiction of the Supreme Court and are settled by bringing an *action* in that court in which the trustee is the party-plaintiff and the beneficiary the party-defendant or, in certain cases, by a special proceeding. There is a possible exception to this rule of exclusive jurisdiction in the case of common trust funds, which banks and trust companies are authorized to establish by law passed in New York in 1937 and amended in 1943, in order to provide for the investment of many small trusts in a common fund. The law permits the trustee of a common trust fund to account either in the Supreme Court or the Surrogate's Court, even though the fund may include *inter vivos* trusts. Interpretation of the statute, however, has been the subject of conflicting decisions by Surrogates of two different counties and the question is awaiting final adjudication by the Court of Appeals.

Testamentary Trusts

Accounts of trustees under wills are settled in the Surrogate's Court in *proceedings* (as distinguished from *actions* in the Supreme Court). The trustee files a full and complete account of his dealings with the trust and a petition praying for its approval by the Court. Every beneficiary is cited to appear and is thus given opportunity to file objections if he has any. The Court's judicial approval is expressed in its order or decree judicially settling the account. An account so settled is finally and conclusively binding on all parties to the proceeding of whom jurisdiction was obtained, and all persons deriving title from them, as to all matters embraced in the account and the decree. The Court also has power to compel an accounting at any time by order made upon the petition of any person interested or on the Surrogate's own motion, by an executor, administrator or testamentary trustee.

Recent Developments in Accounting for Corpus and Income

By John J. Traynor, C.P.A.

Introduction

One of the aims of this Committee is to bring to the attention of the Society's membership selected cases and statutes relating to problems involved in the allocations in fiduciary accounts between corpus and income. A few recent cases are reported herein.

It is strongly urged, however, that in preparing or auditing fiduciary accounts, accountants should seek the advice of counsel on all questions involving the law as applied to any given situation.

Depreciation

In a recent case, extensive consideration was given to the question of depreciation reserves in respect of real property held by testamentary trustees.

At the date of testator's death, he held five apartment house properties and owned the entire stock of two corporations, each of which owned an apartment house. Each corporation was dissolved at the close of the fiscal year following the testator's death on March 11, 1943, and the real properties conveyed to the trustees under the will. The aggregate value of all the properties at the date of death was $1,289,500, and the annual rents approximately $230,000. The annual depreciation, at a 2% rate in testator's income tax returns, was about $20,000.

Testator's will authorized the trustees to pay the net annual income "after making proper and suitable allowances for expenses and setting up a reserve or sinking fund to meet taxes or other contingencies."

The court noted that the testamentary plan must be examined with a realization that the testator incontrovertibly was engaged in the business of real estate-building, selling and operating of real properties.

The court held that the trustees not only may but are bound to set up a reserve out of income for depreciation of the buildings embraced in the corpus of the trust. It directed that the trustee set up a reserve out of gross rental income for depreciation of buildings, conforming to testator's practice in filing his income tax return. For this purpose, the depreciation is to be limited to physical and material depreciation and obsolescence as distinguished from economic depreciation, such falling on remainders.

Significant is the holding that such depreciation reserves are not irrevocably to be allocated to corpus but "that their disposition as between income and principal is expressly reserved for determination until such time as the trust has been terminated, or upon an earlier application when the facts shall warrant such determination."

The court here has favored us with an exhaustive analysis of the cases on this subject and its opinion is worthy of careful consideration for undoubtedly it will bear on many situations.

—*Matter of Elies Kaplan,* 88 N.Y.S. (2d) 851.

John J. Traynor, C.P.A., was elected to membership in the Society in 1928, and is Chairman of its Committee on Fiduciary Accounting. He is associated with the law firm of Breed, Abbott and Morgan.

This paper was presented at a technical meeting of the Society held at the Engineering Societies' Building on May 12, 1949, under the auspices of the Committee on Fiduciary Accounting.

Accrued Interest on Bonds

The settlor of the trust, on December 15, 1924, executed an agreement with the National City Bank by terms of which certain bonds with coupons attached were assigned, transferred and set over to the Trustee to be held in trust by it for the purposes named in the indenture. The securities which were delivered pursuant to the terms of the agreement and the additions to the trust fund were inventoried at their respective market values, but these values did not include the interest on the bonds which had accrued from the last interest date to the date of the transfer of the securities to the Trustee.

When the first interest coupon became due on each of the bonds the entire amount thereof, including the amount of the interest accrued to the date of the gift, was allocated and paid to the income beneficiaries.

The infants' guardians contended that the accrued interest became part of principal and therefore should not have been paid over to the income beneficiaries.

The Trustee in an endeavor to sustain its position offered a letter written by the settlor stating that it was his intention when the trust was established that accrued as well as accruing income be paid to the life beneficiaries. The Court would not accept such letter in derogation of the language of the trust indenture.

The Court held that the accrued interest at the date the bonds were transferred to the trust properly belonged to principal and not income and that a different result would follow only if the settlor evidenced that there would be no apportionment of the interest. (*Nichols* v. *Stevens,* 187 N.Y. 471; *New York Life Insurance Co.* v. *Baker,* 165 N.Y. 484; *Matter of Jones,* 155 Misc. 315; *Matter of Fithian,* 103 Misc. 568).

—*Matter of National City Bank of New York,* 87 N.Y.S. (2d) 128.

Stock Dividends

As to trusts created after May 17, 1926, unless otherwise provided in a will or instrument, stock dividends received on principal investments form part of principal. The rule also applies to stock dividends paid regularly from current earnings. Dividends paid in stocks of other corporations, however, do not fall within the rule and this is illustrated by a recent case where one of the assets of the trust was stock of the American Light & Traction Company, which company was directed by the S.E.C. to dispose of its interest in the common stock of Detroit Edison Company. The approved plan in part provided for payment of regular quarterly dividends during 1948 in stock of Detroit Edison and for distribution of any undistributed and unsold shares of Detroit Edison on hand at the end of the year, as a special dividend.

The income beneficiaries were held entitled to receive the Detroit Edison shares to the extent that such stock dividends were declared in lieu of the payor company's usual quarterly dividend but any special dividend, if paid out of the capital assets of American Light & Traction Company, constituted principal and became part of the corpus of the trust.

The Court noted that "It is not essential for the dividends to be paid in cash in order that they constitute income. Though a dividend is declared in a commodity or the evidences of title to a commodity, it must be treated as if it were a cash dividend.[1] Thus where the dividend is to be paid in stock of another corporation, even a subsidiary corporation, it will remain income exactly as it would be if payable in cash. It is not a stock dividend, but a cash dividend payable in stock.[2] Where so-called extraordinary dividends are paid out of capital assets, whether in the form of cash or stock, they constitute a distribution of capital. Thus extra-

[1] *Matter of Wolfe,* 155 Misc., 190.

ordinary dividends declared as a result of reduction of the capital of the corporation and really paid out of the capital assets of the company constitute capital and not income of the trust fund and are distributable to the remaindermen." [3]

—*Matter of Robert H. Benary,* 86 N.Y.S. (2d) 679, 149 Misc. 271.

Allocation Between Principal and Income of Certain Securities Received by Trustees in Railroad Reorganization Proceeding

The Trustees under testator's will held $25,000 of Chicago & Northwestern Railway 4% Coupon Bonds due November 1, 1987. The bonds were inventoried at $23,495. Default occurred in the interest due November 1, 1935, and default continued until reorganization of the railroad in 77-B proceedings on January 1, 1939.

The bondholders received new securities in amounts corresponding to the face value of the bonds in default plus the accrued defaulted interest. Thus, for each bond of $1000, plus unpaid interest of $146.67 as at January 1, 1939, the Trustees received in satisfaction $202 of mortgage bonds, $470 of income bonds, $434 of preferred stock and $41 of common stock, making a total of $1,147. The new securities were sold by the Trustees for $18,188.06.

Holders of other classes of general mortgage bonds also received new securities of an amount equal to the face value of the old bonds plus accrued unpaid interest.

The portion of the new securities received was so clearly identifiable with the unpaid interest which the life beneficiary would have been entitled to had default not occurred, that the court held that the life beneficiary should have received a proportionate share of the proceeds of sale, to wit:

	Face Value	%	Share of Proceeds of Sale
Old Bonds....	$25,000.00	87.21	$13,861.81
Unpaid Interest	3,666.75	12.79	2,326.25
Total....	$28,666.75	100.00	$18,188.06

This disposition modified the Surrogate's earlier decree (N.Y.L.J., Feb. 24, 1947, p. 730; reaff'd, N.Y.L.J., June 26, 1947, p. 2511, Delehanty, Surr.) wherein the entire sales proceeds were held to be properly credited to principal account in reliance upon *Matter of Otis,* 276 N.Y. 101. There the trustee had exchanged a defaulted mortgage for bonds of the Home Owners Loan Corporation, which bonds were later sold at a loss.

The distinction noted by the court was that in the *Otis* case "the unpaid interest claim was sold with the bond (mortgage) and that the purchase price in new securities was in part measured by the unpaid interest claim. As the reorganization plan was set up and carried out, the new securities received by the trustees were in a very literal sense a product of the unpaid interest claim, which until the surrender of the old bonds in the reorganization the trustees held for the account of the life beneficiary."

—*Matter of Estate of Robert G. Reese,* 275 App. Div. 37; 87 N.Y.S. (2d) 607.

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[2] *Matter of Lavanburg,* 130 Misc., 551; *City Bank Farmers Trust Co.* v. *Ernst,* 263 N.Y., 342; *Matter of Rogers,* 22 App. Div. 428, aff'd, 161 N.Y. 108.

[3] *Matter of Sears,* 176 Misc. 242.

Closed Corporations and Some Related Problems of the Fiduciary

By Arthur B. Moll, C.P.A.
and
Saul S. Silverman, C.P.A.

In presenting this subject, we have placed ourselves in the position of a professional accountant who is faced with the task of preparing an intermediate accounting to the Surrogate's Court covering the administration of the X estate. The problems arising from the preparation of this accounting seem to present no real difficulties except for those arising out of the ownership by the estate of the following securities:

Arthur B. Moll, C.P.A., has been a member of the Society since 1928, is a past Chairman of the Society's Committees on Fiduciary Accounting, on Admissions, on Monthly Audits, and on Library. He is now serving as a member of its Committees on Furtherance of the Objects of the Society, and on Stock Brokerage Accounting.

Mr. Moll is also a member of The American Institute of Accountants. He is a partner of H. E. Van Benschoten & Co.

Saul S. Silverman, C.P.A., and attorney-at-law, has been a member of the Society since 1947. He is a member of its Committee on Fiduciary Accounting.

Mr. Silverman is a Lecturer on Accounting at The City College (New York) School of Business and Civic Administration. He is a partner of Herz and Silverman.

This paper was presented at a technical meeting of the Society held at the Engineering Societies' Building on May 12, 1949, under the auspices of the Committee on Fiduciary Accounting.

Corporation A: The estate owns 40 shares of the issued capital stock. The capital stock is all of one class and a total of 100 shares is issued and outstanding.

Corporation B: The estate owns 80 shares of the total issued of 100 shares of capital stock, which is all of one class.

Corporation C: The estate owns 30 shares and the executor owns 60 shares of the issued capital stock. The capital stock is all of one class, and a total of 100 shares is issued and outstanding.

Statutory Provisions

A reading of the applicable sections of the Decedent Estate Law[1] and the Surrogate's Court Act[2] does not reveal any specific statutory direction as to the requirements of an accounting in situations where an estate or trust owns stock in a closed corporation and, specifically, the statutes contain no directions that would be of aid in connection with the immediate problem of accounting for the ownership of stock in Corporations A, B, and C.

The Surrogate's Court Act does provide generally that an accounting by a fiduciary should reflect all of his receipts and disbursements, both as to principal and income and, also, that such accounting should include details of all of the actions of the fiduciary in the administration of the financial affairs of the estate or trust.[3] In view of the general provisions of the statutes and the absence of any provision cover-

[1] Decedent Estate Law, Sec. 114.
[2] Surrogate's Court Act, secs. 251 to 274, inclusive; sec. 40.
[3] S.C.A., secs. 253, 264, 263 and, generally, secs. 251 to 274; *Estate of Steinberg* (1934) 153 Misc. 339.

ing the situations set forth above, it seems to have been the clear intention of the Legislature to permit the various Surrogates' Courts or other judicial tribunals, to whom an accounting may be submitted, to pass upon the requirements of a proper accounting where the estate or trust owns stock in a closed corporation.

Corporate Entity

Before we begin to discuss the various cases in which the question of what and how the fiduciary should account, where a closed corporation is involved, it may be wise to take up briefly the question of corporate entity and the famous phrase "piercing the corporate veil." Generally, a corporation has been treated by the law as an entity separate from its stockholder or stockholders, and such entity has not been ignored or disregarded except where the corporation is used to defeat creditors of the stockholders, to evade an existing obligation, to circumvent a statute, to perpetrate a fraud, to achieve or perpetuate a monopoly, or to protect knavery or crime.[4]

In addition to the reasons set forth above, the courts dealing with the administration of trusts and estates have also disregarded and ignored the corporate entity where the corporate stock is wholly or substantially owned by the estate or trust.[5] In such cases, the courts have treated the corporate assets as if they were owned directly by the estate or trust without the intervening ownership by the corporation.[6] This action by the courts has occurred principally in cases where the assets owned by the wholly or substantially controlled corporation have been realty.[7] Of course, the courts have never permitted such disregard of the corporate entity to affect the rights of the creditors of the corporation, whose position cannot be affected by the action of the Surrogate in treating corporate assets as estate or trust assets for purposes of the administration of the estate or trust.[8]

It should be noted that this disregard of the corporation entity by the various courts concerned itself not only with the accounting phase of the administration of the estate, but also with all other

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[4] "*The Veil of Corporate Entity*", I. Maurice Wormser, 12 Col. Law Review 496; *Farmers Loan & Trust Co.* v. *Pierson* (1927), 130 Misc. 110; *Estate of Steinberg*, note 3; *Estate of Witkind* (1938), 167 Misc. 885, where the court said, "There is nothing sacrosanct about a corporation. It is not an impenetrable screen behind which facts may be successfully hidden." But see *Brock* v. *Poor*, 216 N.Y. 387, where the court said: ". . . the corporation in respect of corporate property and rights is entirely distinct from the stockholders who are the ultimate or equitable owners of its assets; that even complete ownership of capital stock does not operate to transfer the title to corporate property; and that ownership of capital stock is by no means identical with or equivalent to ownership of corporate property."

[5] *Farmers Loan & Trust Co.* v. *Pierson*, note 4; *Estate of Adler* (1937), 164 Misc. 544; *Estate of Steinberg*, note 3; *Estate of Witkind*, note 4; *Estate of Lesser* (1935), 154 Misc. 364. However, see *Estate of Browning* (1939), 172 Misc. 1088, where the lower court held in accordance with this general rule, but was reversed upon appeal in a strong opinion wherein the court said at 258 A.D. 621, 623, "The fact that all of the stock . . . was owned by the deceased in his lifetime is no justification for administering the affairs of that corporation as if it were a part of the estate."

[6, 7] *Estate of Adler*, note 5.

[8] See *Estate of Dunigan* (1941), 30 N.Y.S. (2) 38, where the court said at page 42: "The entire tendency of the courts in recent years in connection with estate matters has been to view the actualities of the situations and not its fictional superficialities where preponderantly controlled or wholly owned corporations have been involved. In such situations the fact has been recognized that the corporation property was actually that of the testator so long as corporate creditors were not concerned. In furtherance of this conception, fiduciaries have been called upon to detail in their accounts the assets of such corporations and their acts in continuing the business . . ." *Estate of Browning* (1939), 258 A. D. 621.

purposes of the administration of the estate or trust.[9]

It is also important to note that this action by the Surrogate combining, in effect, the assets of the corporation, subject to the prior liabilities of the corporation, and the assets of the estate or trust, has occurred in only a limited number of cases and only where proper application has been made to the court and where there has been a showing that such consolidation aids in the proper administration of the estate or trust.[10]

As a result of these cases we may conclude that, at least at the outset, there is no requirement that, even in the cases of wholly owned corporations, the accounting submitted by the fiduciary must *consolidate* the transactions of the corporation with the transactions of the estate or trust.[11] However, it must be borne in mind that such a direction may be made by a Surrogate in a proper case.[12]

The Importance of the Degree of Control

Having discovered that in some cases the courts have, in effect, thrown the assets of a corporation, wholly or substantially owned by an estate, into the same big pot with the assets of the estate, and that they have required a combined accounting and have thereby disregarded the corporate entity, we now turn to the cases where the corporate entity has *not* been ignored. In these cases, the courts, while maintaining the separation between the estate or trust and the corporation whose stock is owned by the estate, have, nevertheless, required the estate accounting to include all or part of the transactions of the closed corporation.[13]

These situations fall into three main groups which are as follows:

I—The estate or trust owns a minority interest in the corporation, such as X estate's ownership of stock in Corporation A.[14]

II—The estate or trust owns all or at least a majority interest in the corporation, such as the holding of the stock of Corporation B by the X estate.[15]

III—The estate or trust owns stock and the fiduciary, individually, owns stock in the same corporation, the combination of which results in control; or the fiduciary's ownership, alone, results in control; as in the case of Corporation C in the X estate.[16]

9, 10, 11, 12 *Estate of Adler,* note 5.

13 *Estate of Steinberg,* note 3; *Farmers Loan & Trust Co.* v. *Pierson* and *Estate of Witkind,* note 4.

14 See *Matter of Ebbet's Will* (1934), 153 Misc. 775, where the court said: "Whereas experience has rendered this court cautious in making sweeping statements, it may be said that no situation can presently be conceived by it in the usual corporate set-up, in which stockholders, whether fiduciary or individual, who possess less than a majority of the issued stock, could be said to be the real dominating influence in a corporation so as to make the acts of the corporation the acts of the individuals within the principle of respondeat superior. Conversely the court is unable to imagine a situation, where fiduciaries possess such majority holding, in which such situation would not, sooner or later, exist." But see *Estate of Hubbell* (1945) Misc. 59, where the court said: "The accountants [accounting trustees] further urge that the management of the internal affairs of the corporation is solely a matter for the Board of Directors and since the estate is only a minority stockholder, respondents are not entitled to the requested examination. This is the ordinarily accepted rule. *Matter of Witkind,* 167 Misc. 885, 4 N.Y.S. (2) 933. Here, however, by the exercise of his powers as a co-trustee, Henry M. Hubbell has acquired a controlling interest in the corporation as an individual. When a co-trustee gains control of a corporation under such circumstances, the trustees should be obliged to submit to an examination and make a complete disclosure of their acts with reference to the corporate activities. The remaindermen are entitled to such information. . . ."

15 *Farmers Loan & Trust Co.* v. *Pierson,* note 4; *Estate of Steinberg,* note 3; *Estate of Clere* (1940), 23 N.Y.S. (2) 453.

16 *Estate of Witkind,* note 4; *Estate of Hubbell,* note 14.

In situation I, the courts have not required an inclusion in the estate accounting of transactions of the corporation or of financial statements of the corporation.[17] The reasons, therefore, are quite obvious, namely: (a) the fiduciary, having no control, either individually or through the ownership by the estate, exercised no power over the actions of the corporation[18]; (b) the fiduciary would only be able to obtain such information as is available, by state law, to an ordinary stockholder which perhaps may be limited to an annual financial report[19]; (c) the fiduciary would only be accountable for his actions in regard to the manner in which he may have voted or not voted the stock at stockholders' meetings.[20]

In situation II, where the estate has control, the courts have, with few exceptions, required the fiduciary to include information on transactions, financial statements and other data in the estate accounting wherever applications have been made to have such information presented as part of the accounting.[21] In only one case did the court require an affirmative showing of a misdeed by the fiduciary,[22] while in the other cases, the inclusion in the accounting of the corporation's affairs was required merely upon request by parties interested in the accounting.

In situation III, where, either singly or in combination, the estate or trust and the fiduciary have control, the courts have also required the fiduciary to include in the estate accounting financial statements and other data regarding the closed corporation, whereever application has been made to have such information included in the accounting.[23]

The grounds advanced by the various Surrogates as the basis for requiring these inclusions in situations II and III afford interesting reading, especially in regard to the obligation of the fiduciary to maintain the highest degree of integrity in regard to the conduct of the affairs of the corporation.[24] For purposes of our discussion these reasons may be generally summarized as follows:

(a) The control of the corporate affairs by the fiduciary and the consequent power in the fiduciary should be subjected to scrutiny by the beneficiaries whose rights are directly affected

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17, 18, 19, 20 *Matter of Ebbet's Will,* note 14.

21 *Estate of Steinberg,* note 3; *Estate of Witkind,* note 4. See *Farmers Loan & Trust Co.* v. *Pierson,* note 4, where the court said (referring to this case where the trust owned all of the stock of the closed corporation): "In this case the beneficiaries desire only information, and since the trust includes, not only theoretically, but actually and practically, the management of the corporate affairs, and since there is no obstacle or forbiddance in the way of or against furnishing the information, the cestuis (beneficiaries) need to no more than ask for the information in order to become entitled thereto. *Frethey* v. *Durant,* 24 A.D. 58, 48 N.Y.S. 839; *Rose* v. *Durant,* 44 A.D. 381, 61 N.Y.S. 15. It would be a work of supererogation to cite the numerous cases which sustain the right of a cestui que trust (beneficiary) to be informed of his affairs."

22 *Estate of Stewart* (1937), 167 Misc. 361.

23 See *Estate of Witkind,* note 4, where the court said, ". . . where as here the fiduciaries control a corporation by the help of estate stock interest added to the stock interest held personally by one of them they are not disabled to make such accounts and are therefore under obligation to do so."

24 *Estate of Steinberg,* note 3. See *Estate of Witkind,* note 4, where the court said: "The accounting will reveal whether the fiduciary controlling Sagobel and Armin used his power for the private advantage of himself, the executrix or Mr. Cohen with resulting injury to the interest of the estate in its stock or creditor position. . . . The argument that the court thus ignores the distinction between a fiduciary in his representative and in his individual capacities is without merit. There are situations, and this is one of them, where that highly useful distinction must be transcended. It must be transcended here because the fiduciary Mr. Wacht had the advantage of holding the balance of power over the conduct of this corporation solely by virtue of his possession of the estate's one-third interest therein. He cannot successfully put forth his claims of individual detachment from the estate when he has continually been in a position to hold power and derive profit from his fiduciary attachment thereto."

by the fiduciary's exercise of this power.[25]

(b) The fiduciary ordinarily has available, through his control of the closed corporation, complete information as to the transactions and business affairs of the corporation and, therefore, is being asked to report upon and submit information which is readily obtainable by him.[26]

(c) The listing of income and expenses by the fiduciary in his accounting, particularly in regard to the ownership by the estate of stock in a closed corporation, does not provide sufficient information to the other parties interested in the accounting as to the actions of the fiduciary in the conduct of the corporation which he controls through stock ownership by the estate or through the combination of stock ownership by the estate and the fiduciary individually.[27]

It is interesting to note that in a number of cases a fiduciary who, as an individual, owned a controlling stock interest in a closed corporation, was required to render a complete report and accounting of the transactions and affairs of that corporation, merely because the estate owned a minority interest.[28] This raises the interesting problem as to whether a fiduciary, who was the owner of 60% of the issued and outstanding stock of Jones Corp., would be required to follow a more rigid course of conduct than he would normally follow, merely because the estate of which he was the executor also owned 10% of the stock of Jones Corp. It is quite clear that in rendering his accounting as the executor, the executor may be required to include all the transactions and other information concerning the Jones Corp.,[29] but it is easy to see that if thereby his conduct as a majority stockholder is restricted in any way, it may furnish him, and executors or trustees in a similar position, with a strong reason for declining to serve as the fiduciary.

Aside from the problem as to whether the fiduciary should or should not choose to serve as the executor or trustee in situation III, where in combination with the estate or individually he owns a controlling interest in the same corporation whose stock is owned by the estate, or in situation II, where the estate owns a controlling interest in a closed corporation, we believe the cases are quite clear that in such situations the fiduciary must, upon request by other parties interested in the accounting include information as to the transactions of the closed corporation.[30]

Having learned that the fiduciary may be required to include such information in his accounting, we now turn to consideration of the proposition that the fiduciary should voluntarily furnish some information concerning the transactions and affairs of the corporation, in which the estate singly, or in combination with the fiduciary, owns a controlling interest. We wish to make clear that, at present, there is no statutory or other requirement that such information be included in the accounting prior to a proper request by an interested party.

However, it would seem that if such information can be required upon proper request, there is an implied obligation on the part of the fiduciary to furnish such information as part of a proper accounting, even though no request has been made for this informa-

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25 *Estate of Steinberg,* note 3; *Estate of Witkind,* note 4.

26 *Farmers Loan & Trust Co.* v. *Pierson,* and *Estate of Witkind,* note 4.

27 *Estate of Steinberg,* note 3.

28 *Estate of Witkind,* note 4; *Estate of Wainwright* (1945) 55 N.Y.S. (2) 303. To the contrary, see *Estate of Sullivan* (1938) 169 Misc. 16, aff'd., 255 A.D. 1008; *Estate of Browning,* note 8.

29 *Estate of Witkind,* note 4.

30 See *Estate of Steinberg,* note 3, where the court said: ". . . where the fiduciary is a controlling stockholder in a corporation, the transactions through the medium of the corporation are his own acts which must be fully reflected in his account."

tion.[31] The general proposition that an accounting submitted by a fiduciary to the Surrogate should reflect not only receipts and disbursements, both as to principal and income, but also that such accounting should include in detail all of the actions of the fiduciary in relation to the financial affairs of the estate,[32] seems to support this view. In addition, the equitable principle that a fiduciary, who occupies a position requiring a high degree of integrity and honesty, should make a full disclosure of all his actions so that interested parties may make an examination of such activities also furnishes us with additional support for this view.[33]

Inasmuch as the procedure we are advocating is something which would not normally appear in reported cases, since the fiduciary would voluntarily furnish information as to the activities of the closed corporation and, therefore, no contest would ordinarily arise, we decided to consult the Clerks of the various local Surrogate's Courts on this point. As a result of discussions concerning this problem of the inclusion of details of the activities of the closed corporation in an accounting by a fiduciary, it was extremely interesting to learn that such information has been voluntarily furnished only in a very small number of cases.[34] We also learned that some of the clerks do not generally regard such information as a necessary part of the accounting prior to a proper request being made by an interested party.

It also seemed wise to check with the various surety companies as to whether they have any views on the voluntary procedure now being advocated by us. We discussed this question with three of the leading surety companies and we were informed that in connection with the bonds that they issue for fiduciaries, they regard an accounting to have been properly submitted to the Surrogate, even though it does not voluntarily contain or include information as to the activities of the closed corporation.

At this point you may well be wondering as to why we advocate a voluntary inclusion of this information in the face of the fact that (a) the cases are clear that there is no legal requirement, prior to a proper request, to include in the fiduciary account information as to the activities of a closed corporation in situations II and III, where the fiduciary and the estate, whether singly or in combination, have control of such corporation; (b) some of the clerks in the various Surrogate's Courts have indicated that this information has rarely been supplied voluntarily by the fiduciary; and (c) the surety companies with whom this question was discussed do not regard such information as a necessary part of the accounting rendered by the fiduciary.

Before giving you briefly the grounds upon which we rely as the basis for our position, we wish to again emphasize that the procedure we are suggesting is not now required and represents a step forward and one which we regard to be constructive in its results.

Undoubtedly, our major support lies in the fact that the fiduciary, upon a mere request by a party interested in his accounting, must supply any and all information relative to the operation of the closed corporation, which he controls, and that, therefore, he should voluntarily supply such information which thereafter can be reviewed and

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31 *Estate of Witkind*, note 4.

32 *Estate of Steinberg*, note 3.

33 See *Estate of Witkind*, note 4, where the court said: "Moreover, the obligation primarily rests on fiduciaries to make complete disclosures of all relevant data pertaining to an estate. . . . Whether a complete disclosure of all facts made by those who have the facts, namely, the executors, would change the complexion of the matter, cannot be known until all these facts have been formally provided."

34 Unfortunately no statistics are available as to the exact number of cases in which this problem has been raised and this statement only represents a general impression on the part of some clerks in the office of the Clerk of the Surrogate's Court.

examined by the other parties interested in the accounting.[35] It cannot be denied that a proper review and evaluation of the fiduciary's conduct in the administration of an estate or trust requires this information and the fiduciary should have no objection to providing such information as part of his accounting.

We also believe that a fiduciary subjects himself to undue criticism by taking refuge behind a technicality in not providing information as to the closed corporation, and thereby forcing other parties, who are interested in the accounting, to request information which is peculiarly within the knowledge of the fiduciary, easily provided by him and which he will be compelled to reveal and supply, upon such request.

What to Include In the Accounting

Since we are advocating this new procedure whereby the fiduciary will voluntarily include in his account information in regard to the business affairs of the closed corporation over which he exercises control it would only be appropriate for us to go on and to give you what we regard to be the proper inclusions in such cases. It is undoubtedly true that the information to be included in such accounting will vary from one case to another and the following suggestions may not be applicable in every situation.

The other parties interested in the accounting being submitted by the fiduciary should have the following information available to them as part of the contents of the account where the fiduciary has exercised control over the activities of the closed corporation; needless to say, this information should only cover the periods during which the fiduciary has been in control.

(a) Balance Sheets.

(b) Statements of Surplus or Reconciliation of Surplus.

(c) Statements of Profit and Loss.

(d) Details as to corporate salaries of fiduciaries and principal officers.

(e) Details as to important business policies.

(f) Details as to decisions for declaration or non-declaration of dividends.

(g) Details as to transactions between the closed corporation and the fiduciary, his family or any companies owned by him.

(h) Details as to any substantial future commitments.

(i) Details as to any actual or contemplated changes in the operation of the business.

(j) And, generally, any information in regard to any other transactions which would be of interest in the parties of the accounting.

Conclusion

Corporation A: Since no control rests with the fiduciary, no information in regard to these transactions need be included.

Corporation B: Since the estate owned enough shares to give the executor control, such information as was outlined above ought to be included in the accounting.

Corporation C: Since the fiduciary exercised control through the combination of his stock ownership as an individual, and the stock owned by the estate, here, too, information such as Balance Sheet, Statements of Profit and Loss and the other details outlined above ought to be included in the accounting.

[35] See *Estate of Witkind*, note 4, where the court said: ". . . where the court has power to require fiduciaries to report the transactions of corporations in which the estate is interested the question of appropriateness should not be raised. Whether the facts revealed by an accounting in behalf of the corporation's activities are or are not important can only be known after they have been exhibited. As a practical matter therefore in every case, where the court can require disclosure of corporate affairs on an accounting by estate fiduciaries it will exercise its power in favor of disclosure."

An Illustrative Trustees' Commissions Computation Under the 1948 Law

By Emanuel Saxe, C.P.A.
and Abraham J. Briloff, C.P.A.

Preliminary Discussion

The purpose of this paper is to illustrate the computation of trustees' commissions in a trust which began its operations prior to September 1, 1943, and terminated them after April 1, 1948. It will be readily observed that the life of this trust encompasses three periods wherein different rules for the computation of trustees' commissions were in force, viz., (1) that *prior* to September 1, 1943, (2) that *between* September 1, 1943, and March 31, 1948, inclusive, and (3) that *beginning* on April 1, 1948.

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This paper was presented at a technical meeting of the Society held at the Engineering Societies' Building on May 12, 1949, under the auspices of the Committee on Fiduciary Accounting.

Trustees' Commissions Calculations Under Successive Statutes

It would be helpful to review briefly the pattern of the rules governing the computation of trustees' commissions during each of the three periods involved and, in this connection, the comparative chart presented on page 617 may be found useful:

The chart shows that the 1948 amendments clearly indicate a return to the system of compensating trustees (based upon receipts and payments of principal) as it existed prior to the September 1, 1943, revision. A vestige of the latter is still to be found in the retention of an annual additional principal commission, computed at reduced rates and subject to certain ceilings with respect to the aggregate amount thereof.

Transition Problems

One of the interesting problems arising under the new act is that of carrying out the change in laws in the case of trustees' commissions computations begun under the previous statutes and continued or concluded under the present one. This is discussed in the accompanying illustrative case.

The following situations might present themselves in this connection:

I (a) The trustee might have been allowed receiving and, in a proper case, partial paying

COMPARATIVE CHART OF THE RULES GOVERNING THE COMPUTATION OF TRUSTEES' COMMISSIONS IN THE STATE OF NEW YORK

Trustees' Commissions*	Prior to September 1, 1943	Between September 1, 1943, and March 31, 1948, inclusive	On and after April 1, 1948
Lump Sum (Receiving and Paying) Principal Commissions	*For receiving and paying principal:* 5% on first.............. $ 2,000.00 2½% on next............ 20,000.00 1½% on next............ 28,000.00 2% on balance, over...... $50,000.00 (Payable on formal accounting)	*None, except as noted below:* This form of principal commissions was abolished, except for saving clause with respect to unwithdrawn receiving commissions in trusts created prior to September 1, 1943 (Payable on formal accounting)	*Receiving and paying commissions restored at higher rates:* (the same rates as for income commissions) 6% on first.............. $ 2,000.00 3% on next.............. 10,000.00 2% on balance, over...... $12,000.00 (Payable on formal accounting)
Annual Principal Commissions	*None*	*New annual principal commissions allowed* in place of receiving and paying commissions on principal. Computed at 110% of annual income commissions. (Payable on annual rest; subject to limitation on aggregate amount thereof; minimum commissions were also prescribed in the law.)	*Annual additional principal commissions* retained at reduced rates: $1.00 per M* on first....... $ 50,000.00 .45 per M on next....... 350,000.00 .30 per M on balance, over $400,000.00 * or major fraction thereof. (Payable on annual rest; subject to limitation on aggregate amount thereof.)
Annual Income Commissions	5% on first.............. $ 2,000.00 2½% on next............ 20,000.00 1½% on next............ 28,000.00 2% on balance, over...... $50,000.00 (Payable on annual rest)	*Rates increased:* 6% on first.............. $ 2,000.00 3% on next.............. 10,000.00 2% on balance, over...... $12,000.00 (Payable on annual rest)	*No further change in rates:* 6% on first.............. $ 2,000.00 3% on next.............. 10,000.00 2% on balance, over...... $12,000.00 (Payable on annual rest)
Governing Statutes	Surrogate's Court Act, Sec. 285	Surrogate's Court Act, Sec. 285-a, as added by Laws of 1943, chapter 694, and as subsequently amended. See, also Civil Practice Act, Sec. 1548, as added by Laws of 1943, chapter 695, and as subsequently amended.	Surrogate's Court Act, new Sec. 285-a, as added by Laws of 1948, chapter 582, which also repealed the prior Sec. 285-a. See, also, Civil Practice Act, Sec. 1548, new Sec. 1548, as added by Laws of 1948, chapter 594, which also repealed the prior Sec. 1548.
References to More Detailed Discussion	*Estate Accounting*, by Emanuel Saxe; The City College Store Press (1939 Ed.); Chapter 9 (Commissions), pages 109-134.	*Recent Changes in New York Law Governing Trustees' Commissions*, by Emanuel Saxe; *The New York Certified Public Accountant*; November, 1943; Vol. XIV, No. 2; pages 52-58.	*Trustees' Commissions Under the 1948 Law*, by Emanuel Saxe; *The New York Certified Public Accountant*; July, 1948; Vol. XVIII, No. 7; pages 507-511.

*** It should be noted that Sec. 285 of the Surrogate's Court Act, regulating the commissions of executors, administrators and guardians, remained unchanged throughout this entire period.**

commissions on principal, by decree entered prior to September 1, 1943.

or (b) The trustee might have been allowed receiving commissions on principal, under the "saving" clause in the superceding statute, by decree entered on or after September 1, 1943.

II (a) The trustee might not have retained any annual principal commissions because of the statutory direction to credit them against previously withdrawn principal commissions, or for any other reason.

or (b) The trustee might have retained annual principal commissions only *after* the aggregate amount thereof, to which he would otherwise have been entitled but for the statutory direction to credit them against previously awarded and withdrawn principal commissions, equalled the amount of said principal commissions, whether under I (a) or I (b), above.

In the case of trustees' principal commissions allowed and retained under I (a) or I (b), above, it is our opinion that any further receiving and paying commissions on principal allowable under the 1948 act are computed at the new 1948 rates in the bracket reached in the last previous computation. This is the same procedure as is followed in a final accounting following a previous intermediate accounting.

In the case of trustees' annual principal commissions not retained under II (a) or II (b), above, the trustee may now retain an amount equal to one-half thereof.

However, in the case of such annual principal commissions as were previously retained (as in II (b), above), the trustee must return to the trust fund an amount equal to one-half thereof, by deduction from any commissions subsequently allowable under the 1948 act for receiving and/or paying principal.

Facts in the Illustrative Problem

In order to illustrate the foregoing discussion, an illustrative problem is next presented based upon the facts set forth in the accompanying chart, on page 619.

The Trustees' Commission Computations

I—Commissions Allowable During Period Prior to September 1, 1943

a. *On 1942 Income:*

	Base	Commission
5% on first	$ 2,000.00	$100.00
2½% on balance	18,000.00	450.00
Totals.................	$20,000.00	$550.00

NOTE: Since the gross value of the principal of the trust fund accounted for exceeds $100,000.00, *each* trustee is entitled to a *full* commission in this and all subsequent computations.

SUMMARY STATEMENT OF THE ACTIVITIES OF RICHARD DREW AND ROBERT DAY, TRUSTEES UNDER THE LAST WILL AND TESTAMENT OF ALBERT ADAMS, DECEASED, FOR THE PERIOD FROM JANUARY 1, 1942, THROUGH DECEMBER 31, 1948

AS TO PRINCIPAL	TOTAL	1942	1943	1944	1945	1946	1947	1948
CHARGES:								
Original Inventory	$250,000.00	$250,000.00	$ —	$ —	$ —	$ —	$ —	$ —
Realized Increases	20,000.00	5,000.00	6,000.00	—	—	—	3,000.00	6,000.00
Total	$270,000.00	$255,000.00	$ 6,000.00	$ —	$ —	$ —	$ 3,000.00	$ 6,000.00
CREDITS:								
Realized Decreases	$ 10,000.00	$ 2,000.00	$ 3,000.00	$ —	$ —	$ —	$ 2,000.00	$ 3,000.00
Administration Expenses	25,000.00	3,000.00	13,000.00	1,000.00	2,000.00	2,000.00	2,000.00	2,000.00
Debts of the Decedent	5,000.00	5,000.00	—	—	—	—	—	—
Distributions from Principal	60,000.00	60,000.00	—	—	—	—	—	—
Total	$100,000.00	$ 70,000.00	$16,000.00	$ 1,000.00	$ 2,000.00	$ 2,000.00	$ 4,000.00	$ 5,000.00
BALANCE OF PRINCIPAL	$170,000.00							

AS TO INCOME	TOTAL	1942	1943	1944	1945	1946	1947	1948
CHARGES:								
Interest and Dividend Income	$105,000.00	$ 20,000.00	$15,000.00	$14,000.00	$14,000.00	$14,000.00	$14,000.00	$14,000.00
CREDITS:								
Administration Expenses	$ 8,000.00	$ 1,000.00	$ 2,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00
Distributions from Income	97,000.00	19,000.00	13,000.00	13,000.00	13,000.00	13,000.00	13,000.00	13,000.00
Total	$105,000.00	$ 20,000.00	$15,000.00	$14,000.00	$14,000.00	$14,000.00	$14,000.00	$14,000.00
BALANCE OF INCOME	None							

Notes: (1) An intermediate account of proceedings was duly settled as of December 31, 1942.
(2) A final account of proceedings was duly settled as of December 31, 1948.

b. *On Principal, based on intermediate accounting as of December 31, 1942:*

	Receiving Base*	Receiving Commission	Paying Base*	Paying Commission
2½% on first ...	$ 2,000.00	$ 50.00	$ 2,000.00	$ 50.00
1¼% on next ...	20,000.00	250.00	20,000.00	250.00
¾% on next	28,000.00	210.00	28,000.00	210.00
1% on balance...	205,000.00	2,050.00	18,000.00	180.00
Totals......	$255,000.00	$2,560.00	$68,000.00	$690.00

Receiving commission	$2,560.00
Paying commission	690.00
Principal commissions...............	$3,250.00

* See III d, *post*, for computation of the respective bases.

II—Commissions Allowable During Period Between September 1, 1943, and March 31, 1948, inclusive

a. *Income Commissions:*

	1943 Base	1943 Commision
6% on first	$ 2,000.00	$120.00
3% on next	10,000.00	300.00
2% on balance	3,000.00	60.00
Totals................	$15,000.00	$480.00

Similar computations for subsequent years produce the following results:

	Base	Commission
1944	$14,000.00	$460.00
1945	14,000.00	460.00
1946	14,000.00	460.00
1947	14,000.00	460.00

b. *Annual Principal Commissions:*

Computed at 110% of foregoing annual income commissions:

	Commission
1943	$ 528.00
1944	506.00
1945	506.00
1946	506.00
1947	506.00
Total	$2,552.00

Since the commissions awarded and paid to the trustees under the prior law, for *receiving and paying* principal, amounted to $3,250.00, the foregoing *annual* principal commissions were *not paid* but were required to be *credited* against the said $3,250.00 until fully recouped.

III—Commissions Allowable During Period Beginning on April 1, 1948

a. *On 1948 Income:*

	Base	Commission
6% on first	$ 2,000.00	$120.00
3% on next	10,000.00	300.00
2% on balance	2,000.00	40.00
Totals	$14,000.00	$460.00

b. *Adjustment for Unwithdrawn Annual Principal for the Years 1943 to 1947, inclusive:*

Although the former Section 285-a of the Surrogate's Court Act required trustees to credit annual principal commissions against amounts previously awarded for receiving and paying commissions on principal, until fully recouped, the new Section 285-a (subd. 9c) now permits the retention of one-half of such previously unallowed commissions.

Accordingly, each of the trustees is now entitled to receive one-half of $2,552.00, or $1,276.00.

c. *Annual Additional Principal Commissions:*

(Principal on Hand, as of December 31, 1948—$170,000.00)

	Base	Commission
$1.00 per M on first	$ 50,000.00	$ 50.00
.45 per M on balance	120,000.00	54.00
Totals	$170,000.00	$104.00

d. *Principal Commissions, Based upon Settlement of This Account as of December 31, 1948:*

	Total	During 1942	1943 to 1948, Inclusive
Receipts of Principal:			
Inventory	$250,000.00	$250,000.00	$ —
Realized Increases	20,000.00	5,000.00	15,000.00
Totals	$270,000.00	$255,000.00	$ 15,000.00
Payments of Principal:			
Administration Expenses	$ 25,000.00	$ 3,000.00	$ 22,000.00
Debts of the Decedent	5,000.00	5,000.00	—
Distributions from Principal	60,000.00	60,000.00	—
Final Distribution	170,000.00	—	170,000.00
Totals	$260,000.00	$ 68,000.00	$192,000.00
Balance—Decreases	$ 10,000.00 (not paid out)		

Since both the receipts and disbursements of principal in 1942 exceed $12,000.00, commissions on the receipts and payments for the years 1943-1948, inclusive, are allowable in this final accounting at 1%, each.

	Base	Commission
Receipts (1943-8) @ 1%	$ 15,000.00	$ 150.00
Payments (1943-8) @ 1% ..	192,000.00	1,920.00
		$2,070.00

Note: Although not involved in this problem, in the event that the income account includes receipts from rents, attention is directed to subdivision 7 of the new Section 285-a, S.C.A., which provides that the net amount of rental income (that is, after deduction for mortgage interest, real estate taxes, water charges, housekeeping charges, etc.) shall be used in the computation of income commissions. In such event, there is also one special allowance of six percent of the gross rents collected, payable for collecting the rents of and managing the real property.

Statutory Restriction on Testamentary Gifts to Charity

By Aaron Kurz, C.P.A.

It is understandable that the unhappy prospect of departing this life may sharpen one's charitable instincts. This change in outlook may occasionally prevail over the testamentary recognition of those who would naturally be entitled to one's bounty. This conflict of interest is further compounded by the state's desire to protect the latter, avoid unnecessary public charges, and discourage sharp practices on susceptible individuals by irresponsible organizations interested in soliciting bequests in their behalf.

The public policy of New York State on this subject was formulated many years ago[1] and is now contained in Section 17 of the Decedent Estate Law. Under certain conditions discussed below, this section prevents the diversion from certain of one's kin to charitable or similar use of more than one-half of the excess of the property owned by a decedent at the time of his death,[2] over the amount of his debts.[3]

The limitation is applicable only to those testators who are survived by a husband, wife, child, descendant or parent. It does not apply to non-testamentary gifts nor to testamentary gifts if the testator is not survived by one or more of the persons enumerated above.[4] Also, since the statute is primarily intended for their protection, only the aforementioned persons may invoke the limitation, regardless of the objectant's financial need.[5] Failure to observe the above limitation does not, of itself, invalidate the will nor the testamentary gift.[6, 7] Upon proper objection the legacy or devise will be reduced to the statutory maximum. This statute therefore merely creates a right on the part of certain surviving kin to enforce a ceiling on the amount which may be bequeathed for charitable or similar uses. That ceiling is arrived at as follows:

1. Gross estate valued at date of death.
2. Less: Debts of decedent.
3. Balance (Item 1 minus item 2).
4. One-half of item 3 is the maximum gift for charitable or similar uses.

It should be noted that item 2 refers only to the decedent's debts in accordance with the express language of the statute. Thus, administration and funeral expenses, legacies and devises are excluded from item 2 in the above computation.

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1 L. 1860, c. 360.
2 *In re Epstein's Estate*, 1941, 176 Misc. 494.
3 *In re Mayers' Estate*, 1947, 189 Misc. 700, affirmed 84 N.Y.S. 2d 895.
4 *In re Hills*, 1934, 157 Misc. 109.
5 *Matter of Rowland*, 1928, 225 App. Div. 118.
6 *In re Donnelly's Estate*, 1939, 172 Misc. 107.
7 *In re Bowker's Estate*, 1935, 157 Misc. 341.

Where the charitable gifts are of fixed amount and are not carved out of the residuary estate, the proscribed excess over the permissible statutory maximum may be readily determined by the above calculation. Such excess is treated as a lapsed or failed legacy. It becomes a part of the residuary estate and is distributed accordingly.

Where the charitable gifts are outright and are provided from the residuary estate, the permissible statutory maximum is calculated in the same way as indicated above. Then, the residuary of the estate is arrived at by deducting the following from the gross estate: administration expenses, funeral expenses, debts, specific legacies, general legacies, elective share of surviving spouse, if any, and also estate taxes, to the extent that the will directs that they be paid out of the residuary estate.[8] Having determined the residuary estate, the amount of the charitable gifts can be ascertained and, also, the extent to which they exceed the permissible maximum. Such excess will be distributed to those who would take in the event of intestacy.[9, 10]

Where the charitable gifts are of remainder interests, distribution is necessarily postponed until the intervening life estates have terminated. Under these circumstances, the statute provides that "no allowance may be made for such postponement for any interest or gains or losses which may accrue after the testator's death." It further provides that the value of the annuity or life estate "shall be computed upon the actuarial value according to the American Experience Table of Mortality at the rate of four per centum per annum" and not upon its actual life or duration. Thus determined, "such value shall be deducted from the fund or property, which is subject to the annuity or life estate, in order to ascertain the value of a future estate or remainder interest passing to such society, association, corporation or purpose."

This statutory provision, which determines the amounts distributable to the charitable remaindermen and the decedent's next of kin, has received different judicial constructions. The Surrogate of Kings County in the Miranda[11] and Gaubert[12] cases, held that at the time the remainder is distributed, the amount payable to the charitable remaindermen is limited to the amount of the maximum permissible gift, as computed above, with the balance distributable as intestate property. The vice in this procedure is that it limited the amount of the charitable gift, ultimately distributable after the termination of the intervening life estates, to the maximum permissible amount calculated at values as at the time of death. The ceiling on testamentary charitable gifts is fixed by statute at values as at the time of death and not as at the time of distribution. On the other hand, the Surrogate of New York County, in the Voelker[13] and Buck[14] cases, earmarked and limited the amount ultimately distributable as intestate property, after the termination of the intervening life estates, to the prohibited excess of charitable gifts calculated at values as at the time of death. Here again, a future value is confused with a present value. This disparity and the error in construction was pointed out and fully explored in a comprehensive and enlightening article by Emanuel Saxe previously published in this journal.[15] Fortunately, the deci-

[8] *In re Mayers' Estate, supra.*
[9] *In re Logasa's Estate*, 1937, 163 Misc. 628.
[10] *In re Gaubert's Estate*, 1937, 164 Misc. 728.
[11] *In re Miranda's Will*, 1934, 151 Misc. 459.
[12] *In re Gaubert's Estate, supra.*
[13] *In re Voelker's Estate*, 1936, 158 Misc. 97.
[14] *In re Buck's Estate*, 1936, 158 Misc. 111.
[15] "The Accounting Problem Arising Under Section 17 of the New York Decedent Estate Law," *The New York Certified Public Accountant*, January 1940, p. 210.

sion in the Mayers' case[16] in 1947, which has been unanimously affirmed by the Appellate Division, First Department, disposes of the previous conflict and error discussed above. In a logical and convincing opinion, which seems more nearly to effectuate the legislative intent, it implements the prophetic conclusion arrived at by Mr. Saxe.

The computation of the maximum permissible gift and the prohibited excess, if any, would proceed as follows:

1. Compute the maximum permissible gift by deducting the decedent's debts from his gross estate and dividing the remainder by two.

2. Calculate the amount of the residuary estate by deducting the following from the gross estate: administration expenses, funeral expenses, debts, specific legacies, general legacies, elective share of surviving spouse, if any, and also estate taxes, to the extent that the will directs that they be paid out of the residuary estate.

3. Deduct from the total residuary estate the amounts thereof *not* bequeathed to charity, whether outright or in trust, and the balance represents the amounts bequeathed to charity subject to intervening life estates.

4. Calculate the present value of the intervening life estates as prescribed by the statute and deduct the total of such value from the amount arrived at through step 3, above. The balance represents the present value of the remainder to charity. To the extent that the present value of this remainder does not exceed the maximum permissible gift to charity, it is valid. The proscribed excess, if any, represents the present value of the future interest which will not pass to charity, but will be distributed as intestate property. At the termination of the trust, the charity will receive that proportion of the trust principal available for distribution which the maximum permissible gift bears to the present value of the whole charitable remainder, even though the amount actually received exceeds the permissible maximum.[17] The next of kin will receive the balance, or that proportion of the trust principal which the present value of the proscribed excess bears to the present value of the whole charitable remainder.[18]

If a will contains a general bequest for one charity and a residuary bequest for another charity and their total exceeds the permissible maximum, the general principle applies that residuary legacies must abate first before general legacies will be required to do so.[19] Legacies in the same class abate ratably.

[16] *In re Mayers' Estate, supra.*
[17] *In re Buck's Estate, supra.*
[18] See note 15, *supra.*
[19] *In re Morris' Estate,* 1940, 175 Misc. 773, affirmed 261 App. Div. 950, and 287 N.Y. 624, superseding, in this regard, *In re Sonderling's Will,* 1935, 155 Misc. 403.

Minimizing Estate Taxes

By Benjamin Harrow, C.P.A.

Savings Through Lifetime Gifts to Spouse

Since the estate tax is based upon the net taxable estate an individual leaves at death, the less he leaves when he dies the lower the tax. This suggests one method of minimizing estate taxes, namely, giving your property away irrevocably during your lifetime. To be sure the transfer of property by gift may be subject to a gift tax, but the gift tax is applied at the lower gift tax rates and brackets, whereas the reduction by gift of a man's estate reduces the estate tax at the higher rates and brackets. More important however is the fact that the 1948 amendments to the Revenue Act have introduced certain new features which make it easier to minimize both estate and gift taxes. One is the principle of the marital deduction under the new gift tax provisions. For gift tax purposes 50% of the value of each gift to a person who is a spouse at the time of the gift is allowed as a marital deduction. No marital deduction is allowed to a nonresident non-citizen, but if the donor at the time of the gift is a citizen or resident, the marital deduction is allowed even if the spouse is a nonresident non-citizen. In addition to the marital deduction, there is the annual $3,000 exclusion for gifts to any one person and the $30,000 specific lifetime exemption.

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This paper was presented by Mr. Harrow at the Sixteenth Annual Conference of the Society on September 20th, 1949 at Saranac Inn, New York.

Gifts to Third Persons

Another new feature in the gift tax law is the provision that a gift by one spouse to any person other than his or her spouse may be regarded as made to the extent of one-half by the other spouse. In the case of such gifts, therefore, the annual exclusion in fact is $6,000, $3,000 for the husband and $3,000 for the wife, and the specific life-time exemption is really $60,000, $30,000 for the husband and $30,000 for the wife. It is optional for the other spouse to treat the gift in this way. Furthermore this provision applies only if each spouse is a citizen or resident of the United States at the time of the gift. For the purpose of this provision in the law, an individual is considered as a spouse if he or she is married to the donor at the time of the gift and does not remarry during the remainder of the calendar year. The election to treat a gift by one spouse as made to the extent of one-half by each spouse is made by the filing of a consent by both spouses by March 15th following the close of the calendar year in which the gift was made.

The Regulations (Sec. 86.3 a) provide that consents affect all gifts made to third parties during the year with the following exceptions:

1. Gifts made during that portion of the year that husband and wife were not married to each other.

2. Gifts made during that portion of the year that either husband or wife was a non-resident non-citizen.

3. The consent may not include a gift of a property interest over which the donor created a power of appointment in the donee spouse with respect to the property interest.

4. In the case of gifts made in part to a spouse and in part to third parties, the consent is effective with respect to the transfers to third parties only insofar as the interests to the third parties are ascertainable at the time of the gift and therefore severable from the interest given to a spouse. This provision covers annuities, life estates, remainders and reversions.

The Regulations also state that the liability for the entire gift tax of each spouse for the particular calendar year is joint and several where a gift to a third person is treated as having been made to the extent of one-half by each spouse.

As to the manner or time of signifying consent, both spouses may do so on one of the gift tax returns filed on or before the 15th day of March following the close of the year, or each spouse may signify the consent on separate gift tax returns where two gift tax returns are filed. If only one gift tax return is filed, both spouses must signify the consent on that return. An executor of a deceased spouse has the power to signify a consent to be taxed under this provision of the law.

As a result of these amendments to the gift tax laws, only 50% of the value of gifts given to one spouse is subject to tax, with the resultant reduction in his net estate of 100% of the value of the gifts. In addition an individual may give away $6,000 each year to any one person and not be subject to tax if consents are filed to treat the gift as coming one-half from him and one-half from his spouse. Under the same principle he may also give away $60,000 during his lifetime without being subject either to gift tax or estate tax, assuming that his spouse does not make any gifts of her own. In this discussion, we are also assuming that none of the gifts is made in contemplation of death.

Estate Tax—Marital Deduction

At this point the marital deduction feature of the estate tax provision should be explored. The value of any interest in property which is included in the gross estate and which passes from the decedent to the surviving spouse, or which has so passed by lifetime gift is allowed as a deduction from the gross estate. This deduction may not exceed 50% of the adjusted gross estate, that is: the gross estate less the deductions for funeral expenses, administration expenses, claims against the estate, unpaid mortgages and debts, etc.

The idea behind the marital deduction is to treat an estate as a community with each member of the community interested in the estate to the extent of one-half, provided the spouses so wish and do so treat the estate. This approaches the treatment of community property before the 1942 amendments to the Code. Theoretically, whatever property is not taxed in the estate of the first spouse to die will be taxed in the estate of the surviving spouse.

Interest in Property and Terminable Interest Rule

Because the marital deduction may result in a considerable estate tax saving, the law defines with careful particularity an interest in property passing from the decedent. The Code leaves no doubt that it includes an interest held by the decedent at the time of his death and his wife in a joint tenancy, tenancy by entirety or a joint bank account. However, the marital deduction is not allowed with respect to terminable interests that pass to a surviving spouse. The reason for this is that such interests would not be part of the taxable estate of the surviving spouse, and it is the principle of the marital deduction to subject the property to eventual tax in the estate of the surviving spouse while excluding it from the estate of the decedent. A terminable interest is one that ends upon the lapse of time, or upon the occurrence of some contingency, or upon the failure of a contingency to occur. A life estate in property left to a wife is a terminable interest and the value of the property subject to the life estate

would not be eligible for the marital deduction.

Exceptions to Terminable Interest Rule

But the law contains some exceptions to the terminable interest rule. If the wife is given a life estate in property and in addition a power of appointment in the property, the marital deduction applies. The power of appointment will subject the property to a tax in the estate of the surviving spouse and hence the principle behind the marital deduction is not vitiated by taking that type of life estate out of the terminable interest rule.

Another exception to the terminable interest rule is in the case of life insurance proceeds payable in installments, where the surviving spouse has a power of appointment over proceeds not used up by such surviving spouse.

However, six separate conditions are set forth in the law before these exceptions apply:

1. The trust must be created by a transfer of property by the decedent either during his lifetime or under the will.

2. The surviving spouse must be entitled to all the income from this trust for life. She must be given substantially "that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust." For example, a provision in the trust that stock dividends should be treated as corpus or that depreciation, depletion, trustees' commissions, shall be charged against income will not disqualify the trust for the marital deduction.

A trust would be disqualified if the primary purpose is to safeguard property without providing the spouse with the required beneficial enjoyment.

3. The income must be payable annually or at more frequent intervals. It is the intention of the law not to bring within the exception to the terminable interest rule a trust providing for the lawful accumulation of income.

4. The surviving spouse must have a power to say who is to get the property, and she must have this power of appointment with respect to the entire corpus, and it must be exercisable in her favor or in favor of her estate. If the surviving spouse has this power but fails to exercise it, the deceased spouse's estate would nevertheless still be entitled to the marital deduction. An unlimited power on the part of the spouse to invade the principal would satisfy this condition. For this condition to be satisfied, the power to appoint the corpus to herself or her estate must be exercisable without the joinder or consent of any other person. If the power can be terminated during the life of the surviving spouse by any event other than her complete exercise or release of the power, the power is not exercisable in all events and the marital deduction would not be allowed. To be exercisable in all events the power must exist immediately following the decedent's death. Limitations of a formal nature such as the giving of notice, or the use of a particular form will not disqualify the trust from supporting the marital deduction.

5. If any person other than the surviving spouse has the power to appoint any part of the corpus, that is all right provided the power is exercisable in favor only of the surviving spouse.

6. The power of appointment must relate to the entire corpus exercisable by the spouse alone and in all events.

Another exception to the terminable interest rule applies to interests which are to end only if the surviving spouse dies within six months after the decedent's death or as the result of a common disaster fatal to the decedent. If in fact the surviving spouse does not die within the six month period, or as the result of the common disaster, the marital deduction is allowed.

Minimizing Taxes Through Trusts

Prior to the 1948 Federal Revenue Act amendments, estate taxes could be minimized by the husband and wife as a community if the husband set up a trust giving his wife a life estate with the remainder going over to the children. Property so set up in trust is subject to the estate tax in the husband's estate, but upon the wife's death there is no tax on the life estate which ceases, nor upon the property in the remainder which goes over to the children. In considering the minimization of estate taxes under the 1948 amendments the emphasis shifts. Now the husband may want a marital deduction with respect to the property set up in trust. He will therefore have to alter his will and give his wife a power of appointment over the property in trust. While there results an estate tax saving in the husband's estate, there will be a tax on the wife's estate when she dies.

Obtaining Maximum Marital Deduction Through Trusts

In revising trusts and wills that were drawn before April 2, 1948 the taxpayer may wish to get the maximum marital deduction in order to minimize the estate taxes to be paid upon his death. He could thus first divide his net estate into two halves. Having in mind the fact that upon the death of his wife there will be another estate tax and a third upon the death of a child, if any, he may proceed to set up his affairs by looking ahead and trying to save taxes even for his wife and child. If he does this he will most likely direct that one-half of his estate be placed in a trust for the benefit of his wife together with a power of appointment in the wife over the corpus of the life estate. The wife, of course, will receive all the income of this trust for life and upon her death the property in trust will be distributable as she directs in her will. This life estate coupled with the power of appointment qualifies as a marital deduction, and since one-half of the estate was made subject to this life estate, the maximum marital deduction will be secured.

The husband will next direct that all taxes and expenses against his estate are to be paid out of the second half of his estate. This is necessary for the reason that the marital deduction is measured by the net value of the property that passes to the surviving spouse and that means the net amount after taxes. Without such a provision the husband's estate might not be receiving the maximum marital deduction.

The balance of the second half of the estate could now be set up in a second trust. The income from this trust will be paid to the wife for life and upon her death to the child. The trust will terminate upon the death of the child in favor of any grandchildren. No marital deduction would apply with respect to this trust since the interest of the wife is a terminable interest. It ceases upon her death and at the direction of the husband it goes to the child. While the value of the property includible in this trust is subject to tax in the husband's estate, it would not be subject to tax in the wife's estate.

As far as the first trust is concerned, the wife could use her power over the trust corpus to set up a trust for the benefit of the child with the property distributable to grandchildren upon the death of the child.

Annuities and Life Insurance Policies

A word should be said concerning annuities and insurance policies. Should a husband bequeath an annuity to his surviving wife, the bequest will not qualify as a marital deduction if the husband has provided that the annuity should be paid to others upon the death of the wife. Under these conditions the annuity is a terminable interest. But if there is a direction that payments be made to the wife's estate upon her death the marital deduction would apply.

With respect to the proceeds of life insurance the surviving spouse must have the sole right to direct the payments of unexpended installments for the marital deduction to apply to the insurance proceeds.

With respect to powers of appointment over unused installments the same conditions apply generally as in the case of trusts with a power of appointment. The annual or more frequent payments of interest or installments must commence not later than 13 months after the decedent's death. In discussing the conditions the regulations appear to construe the law liberally. For example, if payments by the insurer commenced during the decedent's life, it is immaterial that some of the conditions were satisfied before the decedent died. The conditions are satisfied if the wife has the right exercisable annually to require distribution of installments to herself but does not do so, and the installment is then accumulated and held by the insurer. Compliance with formalities, such as furnishing proof of death before the first payment is made, will not disqualify the insurance proceeds from the marital deduction. But to be exercisable in all events the power to appoint must be in existence immediately following the decedent's death.

The words "power to appoint" need not be used in the insurance contract. If the provisions of the policy give the surviving spouse a right which in substance is a power to appoint herself or her estate, the conditions are satisfied.

Disclaimers

Even if property is bequeathed to a surviving spouse, the marital deduction will not apply if the spouse disclaims the legacy. Likewise, a legacy which goes to the surviving spouse because a third party disclaims it is not eligible for the marital deduction.

* * *

In this discussion the assumption is made that a maximum marital deduction in the estate of the first spouse who dies will result in a maximum estate tax saving. A word of caution is necessary. The marital deduction in the first estate is intended to increase the taxable estate of the surviving spouse. For that reason, each situation must be worked out individually. It is possible, for example, that the increased potential tax in the second estate in spite of the saving in tax in the first estate may not result in an overall net saving for both estates.

AN ADIRONDACK VIEW

Financial Fact-Finding. Not so many years ago a man, his wife, and their sixteen year old daughter attended a CPA conference in a resort hotel. As usual, in order to keep the guests busy and happy—and also the cash register at the bar—a bingo game was the evening's social masterpiece. What a game of wits and finesse! The last and largest pot of thirty-odd dollars was won by the daughter.

On the way home she remarked, "Well, now I am ahead in this gambling business; and I can always stay ahead—if I don't play anymore!"

Guess the younger generation shot that horse right behind the ear!

LEONARD HOUGHTON, C.P.A.
of the Adirondack "Chapter"

Disclaiming Opinions on Reports

By Howard V. Swartz, C.P.A.

The Auditing Procedure Committee of the American Institute of Accountants proposes, for action of the membership at the coming annual meeting of the Institute, a restatement of their Statement Number 23. I assume that you have read the text of this statement and of those preceding it.

Extensions of Auditing Procedures, which was adopted and approved by the Institute on September 19, 1939, stated that certified public accountants should not express an opinion on financial statements when exceptions are such as to negative the opinion or when the examination is less in scope than the accountant considers necessary. This thought was given further consideration by the Auditing Procedure Committee and statement 23 was issued in December, 1947. This statement required that where an opinion could not be given that the accountant should plainly say that no opinion was being given. The recent revision of statement 23 which is to come before the Institute meeting does not change this basic thought but is more complete in its exposition, and concludes with the sentence,

> "It is incumbent upon the accountant, not upon the reader of his report, to evaluate these matters as they affect the significance of his examination and the fairness of the financial statements."

At this time we cannot know what action the membership of the American Institute will take in their coming meeting with regard to the restatement of statement 23.

Sponsorship of this statement by the Auditing Procedure Committee and the force of the logic with which it has presented it, would seem to make disclaimers a recognized requirement for all practicing accountants, even though there may be further modification of the language in which the Committee's statement is set forth. I have heard of no organized opposition to the statement of the Committee. There appears to be, however, some reluctance on the part of a substantial number of members of the Institute to accept this statement by the Committee. This reluctance has manifested itself largely in suggestions for modifications of the proposal, rather than in objection to the essence of the requirement for disclaimers.

The denial of an opinion on a financial statement, where considerable work may have been done, seems to some to allow credit grantors to jump to the conclusion that no auditing had been done. Those who hold this view recommend delay of the requirement for disclaimers until credit grantors are more fully informed of the significance of a disclaimer.

Others take the position that the Committee should include with the restatement of statement 23 an illustrative or a standard form for the positive disclaimer of opinion, as was done for the "short-form" report. Those that hold this view see the possibility that without such guide and standard each office, left to itself, will work out phraseology that seems to it to be prop-

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This paper was presented by Mr. Swartz on September 19th, 1949, at the Sixteenth Annual Conference of the Society, held at Saranac Inn, New York.

er and fitting in each case. It is feared that in some cases the disclaimer of opinion may be so softened by "weasel words" that invidious comparisons between practitioners will be made by clients, and pressure brought to bear upon the practitioner to make less definite his position with regard to a statement.

It is not possible in this paper to marshall all the objections which have been raised to the Committee's statement and to give each its proper analysis and shade of inference. The two foregoing examples of objections raised to the statement are typical of many which may differ from them in some particulars. They seem to derive from an apprehension that the course proposed by the Committee will result in clients' dissatisfaction with the work of accountants where, heretofore, exactly similar work had been entirely acceptable. These objections should be borne in mind as other aspects of the subject are considered.

Some have attempted to discern implications from the Committee's statements. Does the Committee frown upon any work which does not result in an examination of the financial statements where financial statements are presented with the accountant's report? Is this statement an instrument to bring pressure upon clients to have satisfactory procedures adopted for their examination under pain of having a denial of opinion appear in the accountant's report? Is it implied that the profession would make greater progress if it refused to issue statements accompanied with the name of a practitioner unless those statements and supporting records have been examined to an appropriate extent.

Quite properly, from my view, the Committee did not discuss implications which may seem to some to flow from the statement. The Committee leaves these entirely to the consideration of the individual practitioner. The Committee has spoken only of the necessity of making our position and reponsibility clear.

According to the Auditing Procedure Committee, there are two occasions on which it is mandatory for the accountant to disclaim an opinion. One is when the accountant's "exceptions are such as to negative the opinion." The other is "when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole."

In the first, the auditor may have attempted to make a satisfactory examination, but has been prevented by circumstances from doing so, or the client may have adopted unsound accounting practices so that important reservations or exceptions would be required from the auditor. When these exceptions become so important as to negative an over-all opinion, the auditor must refrain from giving one and in the report clearly state that an opinion is not given.

The second condition in which an opinion must be denied is that most frequently encountered and seems to be of an entirely different nature. That is when the scope of the audit is insufficient to enable the auditor to give an informed opinion. In such case, the auditor may not be trying to make an audit examination. His purpose is other than the expression of an opinion. Many engagements are not aimed at the audit of financial statements.

In considering the scope of examinations, I have found that some accountants adopt an attitude which is unsound. I refer to the attitude that the client sets the scope of the work. Sometimes, the offhand statement is made, "This is all he was willing to have done," or, "They were unwilling to pay for a more complete examination."

You may remember past discussions as to, "Whose statement is it, the accountant's or the client's?" That was one of those simple questions which required an answer to be on firm footing in financial reporting.

Another question as fundamental is before us. "Who determines the scope of the work, the client or the auditor?"

In Auditing Statement #2, the Com-

mittee on Auditing Procedure has said, "The independent certified public accountant should determine the scope of his examination and the client must rely upon the professional integrity and standing of the accountant for his assurance that no work unnecessary in the circumstances will be undertaken." When the Committee made this statement it had reference to audit examinations. It would not be right to enlarge the area to which their statement applied to include all accounting engagements. Nevertheless, it seems to me that it is entirely appropriate to consider that for all engagements the certified public accountant does determine the scope of the work which he will do to accomplish the purpose for which he has been engaged by a client.

If the accountant determines the scope of his work, he has no reason to throw upon the client the burden for a disclaimer because of lack of scope.

To illustrate a case in which the auditor places upon the client a certain amount of responsibility for a lack of scope in the auditor's work, I quote a report which appears in an article on Statement 23:

> "We have examined the balance sheet of XYZ company as of June 30, 1949 and the related statements of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances except as noted in the immediately following paragraph.
>
> "At your request, and with the understanding that the resulting examination would not be adequate to permit us to express an opinion as to whether the financial statements, considered as a whole, fairly present the financial position of your company at June 30, 1949 and the results of its operations for the year then ended, we did not follow the generally accepted auditing procedures of communicating with debtors to confirm accounts receivable balances and of observing and testing the methods used by your employees in determining inventory quantities at the year end. We do report, however, that during our examination nothing came to our attention which would cause us to question the amounts at which the accounts receivable and inventories are shown upon the accompanying balance sheet. Further comments describing the extent of our examination and presenting our findings follow:"

While it must be apparent that the foregoing report is gracefully worded, the limitation of scope is thrown upon the client in the phrase:

> "At your request, and with the understanding that the resulting examination would not be adequate to permit us to express an opinion . . ."

It may also be observed that in this example the denial of opinion is implied, not affirmatively stated. Furthermore, the statement, "nothing came to our attention which would cause us to question the amounts at which the accounts receivable and inventories are shown . . ." is considered by some to be entirely improper because it attempts in some measure to give assurance, though in a negative manner, when no assurance whatever should be given where an adequate examination was not made.

The Auditing Committee Statement is clear that with respect to every statement an accountant must determine (1) whether he can give an unqualified opinion, (2) an opinion qualified by certain reservations or exceptions, or (3) can give no opinion on the statement taken as a whole. Certain cases are clearly in one or another of these categories. However, the boundary lines between a report in which no qualification is made and a report in which it is necessary to make some qualification are difficult to define and must be left to each accountant to determine for himself.

Similarly, the boundary line between the situation in which an opinion, although qualified, can be given and the situation in which disclaimer of an opinion is called for, is not defined. The profession has taken the position that the distinction between these two must rest on the judgment of the individual practitioner in each particular case.

A number of published articles include examples of phraseology which have been used as disclaimers of opinion. In some, the accountant has denied the opinion on the statement as a whole, but has proceeded to give such substantiation and value as he considered appropriate in view of the work which was done. This is only a natural course for an auditor to take since he is not attempting to deny to his client the benefit of such work as has been done. There can be little doubt that partial opinions require great care in their expression. Otherwise, the reader may be confused when apparently the auditor disclaims an opinion, but indicates that the financial statement may be accepted as fair. Or, the impression may be given that though the auditor has not done some of the things called for by auditing standards and must say that they have not been done, yet the auditor himself believes that sufficient work has been done to establish to his own satisfaction that the financial statement is in the main all right. One could hardly think of a more effective way to depreciate the value of an accountant's opinion.

In disclaiming an opinion because of insufficient scope, I have suggested that the auditor should not cast reflections upon the client or the financial statements, but should make it perfectly clear that he is not expressing an opinion on the statements.

Is it possible to disclaim an opinion without implying a reflection on the good faith of the client or the fairness of his statements? I believe we can if we recognize that, on many accounting engagements, reports may include a financial statement which has not been examined sufficiently for him to express an opinion with regard to it. In such cases, he could clearly and unequivocally state the purpose for which the engagement was undertaken and state, as clearly, that in view of this purpose, it was not planned to perform all the audit procedures which would be required for the expression of an accountant's opinion and that accordingly no opinion is offered as to the fairness of the financial statements.

Perhaps it is unnecessary to state that when the auditor has reason to believe or even suspect that the financial statements are not fairly presented, he should not associate his name with the statement even for the purpose of disavowing an opinion. However, where an opinion is disclaimed, many credit men would like to have the auditor make clearly an assertion to the effect that in the work no evidence was discovered by the auditor to indicate that the financial statement should be changed from the way presented. It would be unfortunate, in my view, if we permit a general custom to develop which requires the inclusion of a negative assertion of this kind in reports where opinions are disclaimed. Though the negative assertion is true, we would not easily drop it from use, and it is entirely unnecessary if credit men are brought to recognition of the fact that an auditor will not associate his name with a statement which he suspects to be false. It would appear that in this area of the non-opinion report we should settle our thinking on some basis generally acceptable and then our professional societies might make that position clear to credit grantors and business people generally.

The Auditing Committee recommends a policy of candor and frankness with regard to representations which we make concerning financial statements. The improved attitude of business toward full and frank disclosure of corporate matters has benefited business by the increased confidence accorded by the public. It would seem that such equal frankness on the part of the professional auditor will add to the esteem in which our efforts are held and a proper recognition of our independent viewpoint and the consequent significance of our opinions.

Verifying the Insurance Loss Claim

—Some Case Materials

By Leo Rosenblum, C.P.A.

In a recent paper in *The New York Certified Public Accountant* the author discussed the provisions of the Standard Fire Insurance Policy of the State of New York which are of particular significance to public accountants.[1] And subsequently, in the *Journal of Accountancy*, he summarized the accountant's tasks under "books and records" clauses in insurance policies.[2]

It was observed in the latter article that, theoretically, in loss estimating the accountant's work is substantially the same whether he represents the insurer or the claimant. But as a practical matter, it was pointed out, a more comprehensive review must be undertaken by the insurance company's accountant because he is less familiar with the claimant's records.

The claimant's internal or independent accountant will have had frequent contact with the records. He might therefore decide to accept without further verification loss figures obtained directly from the records, provided that the figures did not seem improbable or incorrect on their face.

The insurance company's accountant, on the other hand, will usually undertake his initial inspection of the claimant's records at the time claim is made. As a result he will generally check the reliability of the loss claim figures against other data from the books and related records. He will also use financial statements prepared by the insured for other (non-claim) purposes, information in applications for insurance, trade credit reports, periodic inventory schedules, price lists, and similar data.

These points may be rendered more concrete through specific examples. In this paper the writer presents case materials to illustrate situations where detailed analysis and cross-checks were employed in reviewing loss claims.

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CASE MATERIALS

I—What Was the Inventory at the Time of Loss?

In adjusting the fire loss claim of a picture frame manufacturer, consider-

[1] *The Role of the Accountant in Fire Loss Adjustments,* September 1948, pp. 652-6.

[2] *Accountant's Job under "Books and Records" Clauses in Insurance Policies,* February 1949, pp. 135-8.

able difficulty was encountered in reaching an estimate of the inventory of goods just before the loss.

The claimant kept the customary journals and ledgers, but maintained no record of the labor consumed in the production of specific items. It was ascertained that part of the labor was performed by the principal officer of the company. The enterprise was small. Business had been poor during the period under review; for a number of years the annual sales volume had been below $20,000.

The claimant reported that its inventory was $15,500 just before the fire. This represented one and one-quarter times the gross sales in dollars for the eleven and one-half month period since the end of the preceding fiscal year.

A factor in estimating the amount of inventory was the treatment of overhead. The claimant's records shed no light on the question of what proportion of total "expenses" of $9,600 (including the $5,400 salary of the officer referred to above) represented manufacturing expenses, and what part general and administrative expenses. Four independent estimates were therefore made. It was first assumed that manufacturing expenses represented 100% of total expenses; then, 50%; then, 25%; finally, 0%.

The resulting estimates of the inventory value, to be compared with the figure $15,500 advanced by the claimant, were as follows:

% of "Expenses" Considered to Represent Manufacturing Expenses in Estimating Cost of Merchandise Available	*Resultant Estimate of Inventory at Time of Loss (after Deducting Cost of Sales, Computed on Basis of Average Gross Profit Percentage)*
100%	$9,500
50	7,500
25	6,600
0	5,700

The computations supporting these inventory estimates are detailed in Tables I and IA. In Table IA it is assumed that the proportions of "expenses" representing manufacturing expenses (the latter to be employed as elements of cost of production) were, in turn, 100%, 50%, 25%, and 0%.

As further shown in Table IA, this yielded corresponding average gross profits for the three year period preceding the loss of, respectively—1%, 22%, 34%, and 46%. Applying the consequent cost of sales relationships of 101%, 78%, 66%, and 54% to the sales figure for the eleven and one-half month period before the loss yielded the estimated inventory figures tabulated above and also shown in Table I. These inventory estimates range from $5,700 to $9,500, the latter figure being well below the sum of $15,500 submitted by the insured.

The rejection of an excessive percentage of overhead expense in computing the value of merchandise on hand at the date of loss might be based on the reasoning that only part of the "expenses" was properly includible as an element of cost of production and consequently as part of the inventory value of the output. But even acceptance of 100% of the "expenses" as costs of manufacture yielded an inventory figure far below that claimed by the insured.

An interesting sidelight on the matter was shed by the report of the insurance company's appraiser. Inspection of the merchandise and the debris after the loss evoked his opinion that the quantities—as well as the unit values—of many items claimed to have been on hand before the loss were exaggerated. The appraiser estimated the value of the inventory at the time of the loss as $7,000.

TABLE I

Estimated Value of Inventory at Date of Loss on Basis that 100%, 50%, 25%, and 0% of "Expenses" Were Considered To Be Manufacturing Expenses

	% of "Expenses" Treated as Manufacturing Expenses			
	100%	50%	25%	0%
Inventory—June 1	$ 5,700	$ 5,700	$ 5,700	$ 5,700
Add: Purchases, Labor, Processing, Light and Power	6,600	6,600	6,600	6,600
"Expenses" *	9,600	4,800	2,400	0
Total	$21,900	$17,100	$14,700	$12,300
Less: Cost of Sales (Sales $12,300; estimated percentages of cost of sales based on Table IA)				
— 101%	12,400			
— 78%		9,600		
— 66%			8,100	
— 54%				6,600
Estimated inventory at date of loss	$ 9,500	$ 7,500	$ 6,600	$ 5,700

* Including officer's salary of $5,400.

TABLE IA

Estimated Gross Profit Percentages for Three Year Period Preceding Year In Which Loss Occurred (Based Upon Income Tax Returns)

	Year Preceding Loss	2nd Year Preceding Loss	3rd Year Preceding Loss	Total	% of Average Gross Profit after Deducting "Expenses" as Indicated
Net Income from Sales	$15,900	$17,700	$13,400	$47,000	
Gross Profit— per Income Tax Return	7,700	8,800	5,200	21,700	
Expenses	8,100	8,400	5,900	22,400	
Gross Profit after deducting:					
100% of Expenses*	(400)	400	(700)	(700)	(1)
50% of Expenses*	3,700	4,600	2,200	10,500	22
25% of Expenses*	5,700	6,700	3,700	16,100	34
0% of Expenses*	7,700	8,800	5,200	21,700	46

*=Figures rounded to nearest $100
( )=Loss

II—The Novelty Neckties.

A necktie manufacturing firm, located in an eastern city, made claim in December for damage, approximating 80 percent, to a number of lots of merchandise. The loss was caused by seepage of water during the extinguishing of a fire in an adjoining building.

One of the lots consisted of 490 dozen neckties, distinctive because stamped with the emblem of a widely-known fraternal order. The claimant reported that the neckties had been produced during the slow months of the preceding summer on speculation, or experimentally, in anticipation of sale as novelties at the fraternal organization's convention and parade during the following summer.

The manufacturer maintained the customary general books of account, but no inventory record was kept. Examination of the sales books indicated that immediately after being stamped with the fraternal organization's emblem practically the entire output of the special neckties had been shipped, billed at $3.00 per dozen, to an affiliate.

The latter was located in a west-coast city near that of the convention.

This schedule reflects the dates on which the neckties were stamped and the dates of shipment to the affiliate:

Stamped		Shipped	
Date	Dozen	Date	Dozen
June 11	45	June 22	45 6/12
21	32	22	32
22	38	22	38
24	94	24	94
25	36	25	36
25	34	26	34
26	23	26	20
26	55	27	58
27	86	27	86
28, 29	36 4/12	29	37
Total	479 4/12		480 6/12
June 30	22		

The reviewing accountant's check of newspaper files revealed that the fraternal organization abandoned its customary annual parade because the weather was bad. The neckties, it developed, were then shipped back east to the manufacturer, and were in the manufacturer's basement the following winter when the damage through seepage of water occurred.

No formal cost records were kept. However, the claimant reported the cost of production to be $3.30 per dozen, offering in support detailed, though informal, estimates.

Analysis of sales during the year preceding the loss indicated that, excluding the fraternal organization neckties under discussion, 90 percent (in quanity) of the merchandise sold by the claimant had been billed at $3.00 per dozen or less, and 95 percent at $3.30 per dozen or less. Thus the production cost per dozen of the experimental line of neckties was reported to be equal to or greater than the sales price per dozen of 95 percent of the merchandise sold during the year before the loss.

III—Discrepancies between Perpetual and Physical Inventories.

This claim was for the loss of dresses reported to have disappeared on June 20 and 21.

Daily the insured counted the dresses on hand. Each month its accountant prepared a summary showing the number of dresses on hand at the beginning of the month, the quantity produced during the month, that sold, and the balance which should have been on hand. He compared this balance with the end-of-month physical inventory figure provided by the client. Each month there were differences between the two sums, and the book figure was adjusted to agree with the physical inventory.

The claimant's accountant arrived at the figures representing the claim for disappearance by starting with the June 1 physical inventory, adding the number of dresses produced to June 20, deducting the sales to that date, and comparing the result with the physical inventory on June 20. The claim for loss on June 21 was computed similarly, giving consideration to the June 20 loss.

The accountant representing the insurance company compared the daily balance in the perpetual inventory record with the insured's figures for the daily physical count. There were non-balancing shortages or overages almost daily during a period of several months preceding the dates of the losses claimed. These daily differences appeared to reflect carelessness in record-keeping or possible dishonesty on the part of the claimant's staff. The existence of numerous overages and shortages as between perpetual inventory and physical count vitiated reliance upon the insured's records as corroboration of the quantity of dresses missing.

IV—Eight Pages of Correcting Journal Entries.

This claim arose as a result of a fire loss at the premises of a retailer of

radio sets, refrigerators, and electrical appliances. The insured claimed loss or damage of 90 percent to its merchandise. The insurance company's adjusters thought the claim unusually large for the size of the store and the volume of business done.

Numerous bookkeeping records were reported missing after the fire loss. Among these were lists of cash sales and an analysis book listing the undeposited cash sales and the expenses paid in cash. In some cases collections on accounts receivable were listed on ledger cards; in others, on duplicate copies of the sales charge slips; in still others they were apparently omitted entirely.

It was conceded that the records had not been kept properly; to correct them the claimant's accountant prepared eight pages of journal entries as of the date of the loss.

The claim included a large number of items designated by the manufacturers' names and style numbers. Analysis of sales by type and style number showed that as to some styles, the number of units reported lost exceeded the number which the records indicated to be on hand at the date of the loss. In other cases, items claimed to have been consumed in the fire were not found in recent inventories, purchase bills, nor consignment records.

In many cases where specific models of radio sets were reported lost, certain books indicated that more of such items had been sold than, according to other records, were available for sale. The inventory list as of the end of the year preceding the fire included some items not reflected in the records as ever having been acquired. Some of the discrepancies enumerated were doubtless attributable to the failure to describe, by name and style number, sets received on trade-in.

The values placed upon items lost were often much higher than recent purchase prices or values assigned in the most recent inventory. The insurance company's appraiser found that a large number of items reported as new models were actually many years old. For example, a refrigerator listed at the sound value of $250 prior to the loss proved to be an obsolete model, the manufacturer of which had been out of business for four years.

Depreciation and the Maintenance of Capital

By John N. Myer

When in the realm of accounting it is said that a business has maintained its capital it signifies that for a certain period of time the deductions from the revenue of the enterprise have not exceeded its revenue. In other words, all that is necessary for the maintenance of the accounting capital is to break even.

But in the realm of economics the maintenance of capital is another matter for here the word *capital* has a different meaning. It does not signify, as in accounting, the mathematical difference between the dollar amounts of the assets and the liabilities. In economics the word *capital* is used to denote, to put it roughly, things produced by a business or used to produce income. Thus what the economist speaks of as *capital* the accountant refers to as *assets*.

The assets of fundamental importance and which require the greatest investment, particularly in a manufacturing business, are the fixed assets. It follows that when the economist speaks of the maintenance of the capital he refers to the maintenance of the fixed assets and especially to the maintenance of the plant and equipment. And by maintenance of the plant and equipment he means that the net income must be great enough to make it feasible for the business to replace these assets when they are no longer usable or have become obsolete.

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Accordingly, it is of the greatest importance to distinguish between accounting capital and economic capital. The use of the word *capital* without qualification in recent discussions has led to much confusion.

Now in the post-war period of rising prices the business that breaks even from the accounting point of view,—that is, the business which has recovered from its customers the exact amount of its costs and expenses—does not break even in the eyes of the economist or of management. For it has not obtained from its customers a large enough sum of money to replace the plant and equipment which has become exhausted or outmoded and thus it is not able to maintain itself in good operating condition.

Thus management in a period of rising prices is confronted with the problem of securing additional sums of money in order to pay higher prices for the fixed assets it must replace. This money can be obtained in one of two ways: (1) through increased income from operations or (2) through additional investment by owners or new investors.

It appears to be the consensus among economists that it should not be necessary for a business enterprise to have to obtain additional investment in order to maintain itself in operating condition. They hold that a business should be self-perpetuating; its income, in the absence of any plan of expansion, should be sufficient not only to break even in the accounting sense but also to yield a reasonable income to its owners and, in a period of rising prices, to yield an additional sum to cover the

increased cost of replacing the exhausted plant and equipment. It follows that if the additional cost of maintaining the fixed assets is to be obtained through operations, unless costs and expenses can be decreased—which is unlikely—the selling prices will have to be increased. And this is precisely what has been done in almost all enterprises, as everyone knows.

In order to provide the sums necessary for the increased cost of replacement of plant and equipment all that is usually necessary is the adjustment of the selling prices. This, however, is not always as easy as it might seem, particularly in a highly competitive market. It is a problem of sales strategy that must be solved by management.

But there are those who think the problem is one that can be solved by the accountant. They believe that by changing accounting technique a business can get the money to cover the increased cost of replacement of assets. Specifically, they believe that by accelerating the amortization of the fixed asset costs additional money will be obtained. But, like the flowers that bloom in the spring, the amortization of asset costs has nothing to do with the case.

New York State Tax Clinic

(Continued from page 650)

fits. It must set forth the right of the Chairman to enforce, in the name of the people of the State, the liability of the insurance carrier for the payment of benefits on behalf of the person entitled to it.

It must provide that the notice to or knowledge of the occurrence of an injury or sickness on the part of the employer shall be deemed notice on the part of the insurance carrier. Jurisdiction of the employer is deemed to include jurisdiction over the insurance carrier. The insurance carrier "shall in all things be bound by and subject to the orders, findings, or decisions rendered in connection with the payment of benefits under the provisions" of this law.

Insolvency of the employer does not relieve the insurance carrier from the payment of benefits suffered by an employee during the life of the policy.

The insurance contract is not cancellable for the period provided in the contract unless the Chairman and the employer receive a ten day notice of cancellation.

Administrative Expenses

The expenses of administering the law are to be included in the amount to be assessed against employers, carriers and employees.

The law exempts from its provisions any employee who adheres to the teachings of a church whose principles depend for healing upon prayer or spiritual means. The employee is exempt from benefits and the employer is exempt from responsibility for providing benefits.

If an employer makes advance payments of benefits to an employee, he is entitled to be reimbursed out of any benefits payable by the insurance carrier. Minors are deemed to be competent to receive liability benefits.

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

**New York City—
Special Taxes—Correction**

In the September, 1949, issue (p. 581) the erroneous statement was made, "Wines, liquors and other alcoholic beverages are taxed at *3%*." The rate should have been stated as *2%*.

On page 582, the statement was made that the rate of tax on financial businesses is 2/5 of 1%. It should have been emphasized that the tax on financial businesses is computed on gross income, and not on gross receipts as in the case of all other trades or businesses.

It should also be noted that the comment, on page 581, to the effect that the law contains new language regarding the exemption of sales for resale of gas, electricity, refrigeration, and steam, was not intended to imply that such sales were previously taxed. All sales for resale have been exempt from tax since the inception of the law in 1934.

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Taxation of Capital Gains of Estates

An estate is a separate taxable entity and under Section 365 may itself be subject to income tax. The law says that the tax is imposed upon the estate of a deceased person for all income received by it during the period of administration of the estate. The regulations (Art. 242) say that that is so except where the income of the estate during the period of administration is properly paid or credited to any legatee, heir, or other beneficiary. In the latter event such income is taxable to the beneficiary and is allowable as a deduction in computing the net income of the estate.

A capital gain realized by an estate becomes an addition to the corpus of the estate and when it is distributed to a legatee it is not considered to be income properly paid or credited to a legatee within the meaning of Section 365(3). Such income is distributed to the legatee as corpus. That was the holding in *Bank of Richmondville and Holmes, Executors* v. *Graves, et al.*[1] The capital gain is therefore taxable to the estate as an entity and is not an allowable deduction in computing the net income of the estate.

This issue was in the courts recently[2] in connection with Section 162(c) of I.R.C. The will was silent as to the disposition of estate income during administration. The capital gain realized by the estate was distributed to the residuary legatee. The Court held that under the New York law it was not "properly paid" as income and hence was not deductible by the estate. The Court in its decision referred to the case of *Ardenghi* v. *Helvering*[3]

[1] 259 App. Div. 4, aff'd 284 N. Y. 671 (1940).
[2] *Charles Simon & Herman T. Warshaw, Execs. u/w Edward J. Cornish* v. *Jane M. Hoey (Exec. u/w James J. Hoey)* U. S. Dist. Ct. (S. D. N. Y.) April 20, 1949.
[3] 100 F(2d) 406.

which held that "the local law must decide whether a payment is part of the income of the estate * * * properly paid * * * to any legatee" and that "capital gains would not be properly paid to the legatee during administration or settlement of the estate."

The Court relied in part on the *Bank of Richmondville* case[4] which it discusses in some detail. A capital gain represents capital income to the estate, but it is corpus and not income when it is distributed to a legatee as part of the distribution of the total corpus.

There have been some decisions that have held the other way. These were distinguished by the Court in the instant case. In one of them[5] the terms of the will were such that the gain became at once a profit of the legatee.

Under the New York Personal Property Law (Sec. 17a) such income (capital gains) when distributed in its entirety as part of a residuary estate is not "properly paid as income." The result under Sec. 17b would be otherwise if the whole or some part of the residuary estate had been placed in trust.

Community Property Laws

Until the income splitting provisions were enacted by the Revenue Act of 1948, a number of states adopted community property laws in order to receive the favorable tax treatment accorded to taxpayers who lived in community property states. Even the State of New York was considering putting its citizens on a community property basis. Now that married persons in all states may split their income for federal tax purposes there is no longer any tax incentive for adopting community property laws. As a result, a number of states that had introduced community property laws have now repealed them. Only eight states, the original community property states, still have community property laws.

Income splitting for tax purposes has much to commend it. Our State Tax Commission might well consider the advisability of recommending such a provision for State tax purposes. With income splitting the Tax Commission should approve the principle of the marital deduction for estate tax purposes.

The Taxation of Subsidiary Capital

The Missouri Supreme Court recently decided an interesting franchise tax case.[6] In that case a Missouri corporation owned all the stock of two Illinois corporations. The latter companies did no business in Missouri. Missouri included the value of the stock of the subsidiary Illinois Companies in the tax base of the Missouri company. The Court held that the shares of stock were not property and assets in Missouri for franchise tax purposes since the subsidiary corporations operated entirely outside the state and hence the value of the stock was not includible in the Missouri tax base.

Since 1944, New York has solved this situation of the holding company quite intelligently. Subsidiary capital is not subject to the regular franchise tax. It is taxable at the modest rate of ½ of a mill on the first fifty million dollars of subsidiary capital. Such capital includes not only stock of subsidiaries, but indebtedness from subsidiaries on which interest is not claimed and deducted by the subsidiary for purposes of the franchise tax. Furthermore, subsidiary capital may be allocated within and without the state even though the subsidiary company does not have a regular place of business or a permanent and continuous place of business without the state.

In the instant case if the subsidiary companies operated entirely outside the state, all subsidiary capital would be allocated without the state and the parent

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[4] See note 1, *supra*.
[5] *Weber* v. *Com'r.*, 111 F(2d) 766.
[6] *Union Electric Company of Missouri* v. *Morris et al.*

company would not pay any tax to New York on subsidiary capital.

Retail Sales Tax—Exemptions

The City of New York imposes a tax upon the receipts from every sale of tangible personal property sold at retail. Certain articles are exempt, among which are newspapers and periodicals. Books are taxed as tangible personal property. The Court of Appeals recently decided the case of *Business Statistics Organization, Inc.* v. *Joseph*[7] in which the Comptroller sought to tax receipts from subscriptions to Babson's Washington Service and Babson's Business Service as being receipts from sales of tangible personal property. He held that these "services" were not excludible as periodicals. The Appellate Division, with two dissents, had reversed the Comptroller. The Babson Business Service consists of business reports on present economic, political and labor conditions affecting commerce, finance, and industry, which are published at regular periods. Subscribers have advisory privileges. The Court of Appeals affirmed the lower Court on the ground that the publications are periodicals and exempt from the sales tax.

The dissent in the lower court was based upon the Court of Appeals decision in *Moody's Investors Service* v. *McGoldrick*,[8] which held that the statistical information concerning corporations compiled by Moody's was subject to the sales tax. Moody's publishes pamphlets periodically and a bound reference book at the end of the year. The latter is given "free" to the subscribers to the service. Moody's publications were copyrighted as "books" and Moody's gave no personal services in connection with the sale of the publications. The weekly pamphlets were publications of the component parts of the reference book issued at the end of the year.

Babson's publications were vehicles for the transmission of news, opinions, ideas, and information. They have, the court says, the common elements of periodicals, periodicity, general availability to the public and continuity of title and content from issue to issue. "They do not usually possess a substantial and permanent binding and the writings contained therein are customarily the product of an editorial staff rather than a single author."

The services were actually classified in the United States copyright office as "periodicals." But technical distinctions between periodicals and books for postal and copyright regulations are not conclusive in a sales tax case.

Article 9A—Sec. 210.10—Value of Rented Property for Inclusion in the Property Factor

How is rented property to be valued for inclusion in the property factor? We have already discussed some of the problems involved in this new provision in Article 9A. The State Tax Commission is working on a regulation that will effectively apply this new section of the law. It has enlisted the aid of our Committee on State Taxation by requesting suggestions and by conferring with a group of our members.

Some of the problems raised by the new provision are not difficult of solution. Rental costs should include interest, taxes, and insurance, if the lessee is required to pay these under the terms of the lease. The rental cost will be capitalized by some factor to be determined by the Tax Commission on the basis of an expert study of the ratio of rent to value over a representative period of time. This period will cover both a rising and falling real estate market. For simplicity of administration a single factor will be provided for with a right in the taxpayer to request the use of a different factor if he can establish any inequity in the use of the single factor.

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[7] July 19, 1949.
[8] 280 N. Y. 581.

The Tax Commission is aware that the case of an option to purchase may present some difficulty. Rental payments may reflect the cost of the option and a lease may provide that rental payments are to be applied against the purchase price. This situation will require individual treatment and is difficult to handle in a general regulation.

Rented space in a warehouse is includible in the rent factor. However if the warehouse man is a mere bailee, storage charges would not qualify as rent and so would be excluded from the property factor. The regulations will probably note the distinction between the landlord-tenant relationship and the bailor-bailee relationship, in the case of space in a public warehouse.

The major difficulty will be the problem of valuing buildings and improvements erected by the lessee. The regulations will probably make a distinction between buildings and improvements which become the property of the lessee and those which become the property of the lessor. In the former case the cost of the buildings and improvements have always been includible in the property factor. As to those buildings and improvements that revert to the landlord the annual amortization could be included in the rental costs to be capitalized. An alternative suggestion is to exclude any amortization from rental costs and instead include in the property factor a constant amount equal to one-half the cost of the improvement during the amortization period.

There is another problem. How should leasehold improvements be valued during the term of a renewal tenancy where these have been fully amortized during the period of the original lease? One solution would be to include as rental costs the amortization taken on the federal return. Under the Internal Revenue Code (Sec. 29.23 (a)-10) amortization may be taken over the period of the original lease "unless . . . the facts show with reasonable certainty that the lease will be renewed."

Mortgage Tax—Lease and Executory Contract of Sale

Under Sec. 253 of the Tax Law the State imposes a mortgage recording tax on mortgages. Under Sec. 240, an executory contract for the sale of real property under which the purchaser is entitled to possession is deemed to be a mortgage for the purpose of this tax. In the case of *Drobner* v. *Chapman*[9] a mortgage tax was imposed upon an instrument providing for the lease and sale of real property. The tenant was to pay a rental of $15,000 a year for twenty years. At the expiration of the term of the lease the landlords were to convey the premises to the tenant without further consideration. A deed was executed concurrently with the lease and deposited in escrow. All taxes were to be paid by the tenant as well as the fire insurance premiums. The tenant was likewise to pay for all repairs and other operating expenses and he was permitted to make major structural changes. Another important provision in the lease was the agreement on the part of the landlord not to encumber the premises during the life of the lease.

The Court held that this particular lease was an executory contract of sale and taxable as a mortgage. The tenant was really paying the purchase price of the property in the guise of rent. There would seem to be no difficulty in agreeing with the Court. In the course of the opinion the Court says that the taxing authorities are not bound by labels and may look to the actualities of a situation. It refers to *Matter of N. Y. World Telegram Corp.* v. *McGoldrick*[10] as a case in point. Readers will recall that the Court in this case held that an agreement be-

[9] N. Y. Sup. Ct., App. Div., 3rd Dept., June 28, 1949.
[10] 208 N. Y. 11.

tween a newspaper publishing company and an equipment company whereby the former was to lease all equipment and real estate of the latter with an option to purchase was a "conditional sale." The Court also says that tax liability may not be evaded by the form of a contract alone, and refers to the case of *Helvering* v. *Clifford*,[11] which taxed a grantor on the income of an irrevocable short-term trust.

The instant case was distinguished from *Rogers* v. *Graves*[12] where a bank had a ninety-nine year lease of premises paying a yearly rental amounting to 5% of the purchase price, and at the expiration of the lease exercised an option to buy the property at an agreed price. The annual rent in that case formed no part of the purchase price. The bank was in possession as a tenant during the term of the lease.

To avoid the mortgage tax in a situation of this kind the lease and purchase provisions should be separated and the periodical rent should form no part of the ultimate purchase price if the option to buy is exercised.

Foreign Corporations

A foreign corporation, that is one organized outside the State of New York, which wishes to carry on its activities (do business) in New York must obtain a certificate of authority from the Secretary of State. This qualifies it to do business in New York. The conditions with which such a corporation must comply are, among others, the designation of the Secretary of State as its agent upon whom process may be served, the location of its office within the State, and the business proposed to be done within the State (Sec. 210, General Corporation Law). The Department of State collects a fee of $100 for the issuance of the certificate.

The foreign corporation that does business in New York becomes subject to a license tax measured by the issued capital stock employed within the state. The rate is 1/8 of 1% where the stock has a par value, and six cents a share if the stock has no par value. Stock employed within the state is determined by taking the ratio of gross assets employed within New York to total gross assets exclusive of cash and United States obligations. The license tax is payable even though the corporation has not obtained the certificate of authority. If the corporation's activities in New York are confined strictly to interstate commerce it is not subject to the license tax.

A certificate of authority to do business in New York will not be granted to a foreign corporation if its name conflicts with one in use within the state. This situation results in a dilemma. The foreign corporation must do business without legal authorization presumably subjecting itself to the penalty of not being permitted to sue in the courts of this state and, at the same time, it is subject to the license tax and the annual franchise tax. Under the General Corporation Law (Sec. 219) the Attorney General may bring an action in the Supreme Court for an injunction restraining a corporation from doing business without obtaining a certificate of authority.

Real Estate Corporation Owned or Controlled by a Business Corporation

Whenever substantially all the stock of a real estate corporation is owned or controlled directly or indirectly by a business corporation, or whenever the same interests own or control both the real estate corporation and the business corporation and, in addition, *any material part* of the property of the real estate corporation is used or occupied by the business corporation, the real estate corporation becomes taxable under Article 9A as a business corpora-

[11] 309 U. S. 331.
[12] 279 N. Y. 375.

tion. A combined report may be permitted or required.

What constitutes a material part of the property of the real estate corporation is not stated in the law and presumably that would have to be determined on the facts and the general meaning of the word "material".

Our attention has been called to another situation affecting the tax on the real estate corporation when it loses its classification because it is controlled by a business corporation and a material part of its property is used by the business corporation. As a real estate corporation it was subject to an additional tax of 2% on all dividends paid during the year. The term "dividends" includes 90% of interest paid on debenture bonds, certificates of indebtedness, certificates of beneficial interest, or promissory notes, if the proceeds of the indebtedness are used to acquire assets and the indebtedness is due to any stockholder or to the members of the immediate family of the stockholder. This provision has been construed to apply to all interest paid either to a stockholder or a nonstockholder, except in the case of promissory notes or other unsecured indebtedness which are considered as dividends only if held by a stockholder. Interest on secured bonds is not taxable as a dividend under this section, whether paid to a stockholder or a nonstockholder.

Upon a change in classification this item of interest receives less favorable treatment. In determining entire net income under Article 9A, 90% of all interest on indebtedness directly or indirectly owed to any stockholder or to members of his immediate family owning in excess of 5% of the issued capital stock of the corporation is not allowed as a deduction. Under this provision no distinction is made between secured bonds and unsecured indebtedness, nor is any distinction made between indebtedness incurred to acquire assets and other indebtedness. As a real estate corporation such interest was either not taxed at all or taxed at the rate of 2%. As a business corporation the inclusion of such interest in entire net income subjects it to a tax at the rate of 5½%.

The change in classification also subjects the real estate corporation to a 2% tax on the excess of the actual net worth of the corporation over the actual paid in capital, generally the undistributed surplus of the corporation. Unfortunately it is not the book surplus that is used, but the surplus based upon the market value of the assets at the time of the change in classification, which means any appreciated value of the real estate.

Discretionary Adjustments of the Business Allocation Formula

The adoption of the Massachusetts allocation formula in the 1944 revision of the franchise tax law (Art. 9-A) was intended to result in a fair apportionment of a taxpayer's income within and without New York. At the same time it was realized that no set formula would do justice to all taxpayers. Hence the law itself (Sec. 210.8) provides that the Commission may adjust the business allocation percentage if it is satisfied that the regular formula does not properly reflect the business activity of the corporation within the state. The regulations (Art. 415) in fact state that "experience in this and other states which impose similar franchise taxes has shown that due to the nature of certain businesses the formula may work hardships in some cases, and not do justice either to the taxpayer or to the state." Some other formula may be employed by the tax commission which will more accurately reflect the business activity of the corporation within New York.

The statute provides that one or more of the factors in the allocation formula may be excluded. Since there are only three factors the application of this provision alone could be sufficient to satisfy many a complaining taxpayer who unjustly gets the full impact of the regular formula. The statute also gives the Tax Commission

the power to include other factors, specifying expenses, purchases, and contract values. The Commission however is not limited to these, since there is a catch-all provision in the statute giving the commission the power to use "any other similar or different method calculated to effect a fair and proper allocation of the income and capital reasonably attributed to the state. . . ." Even in the use of any of the regular factors: tangible property, receipts, and pay roll, it may exclude one or more assets in computing the factor. If this method is employed, the Commission must also exclude any income from such assets in determining entire net income.

With respect to the application of the above provisions the Tax Commission is obliged to publish rulings indicating the circumstances under which such adjustments will be made.

Disability Benefits Law

The 1949 Legislature amended the Workmen's Compensation Law and the Tax Law, by providing for the payment of benefits to employees for disabilities resulting from non-occupational injury and sickness. The law became effective on April 13, 1949, (Chap. 600 Laws of 1949) and is known as the Disability Benefits Law.

Provisions for Coverage

The law covers all employees who work for a covered employer, one subject to the law. A covered employer is one who has four or more employees on each of at least 30 days in any calendar year, commencing July 2, 1949. The law does not cover employees of the state or its political subdivisions, farm laborers, casual employment, golf caddies, or students who attend school during the day and work during vacations. Likewise it does not cover employees of organizations operated exclusively for religious, charitable, scientific, or educational purposes, nor employees subject to the Federal Railroad Unemployment Insurance act, nor maritime employees. The term "employment" covers all work localized within the state even though some of the work is performed without the state.

The law is intended to cover disability resulting from injury and sickness not arising out of the regular employment.

Once the employer becomes subject to the law he remains covered until the end of the calendar year in which he does not have the required four or more employees.

Provisions for Benefits

An employee becomes eligible for disability benefits after he has been employed for four or more consecutive weeks, and continues to be eligible for a period of four weeks after the termination of the employment.

Disability benefits will start after June 30, 1950, beginning with the 8th consecutive day of disability. The disabled employee is entitled to receive one-half of his average weekly wage (computed on the basis of the total wages for the eight-week period preceding the disability). The maximum benefit is $26, and the minimum $10. Such benefits continue for a maximum period of 13 weeks in any one year. The employee is not entitled to disability benefits if he is not under the care of a physician, nor are female employees entitled to benefits for disabilities caused by pregnancy. No employee is entitled to benefits for any day of disability during which he performs work for which he is paid, nor for any day of disability for which he is entitled to receive from his employer or from a fund to which the employer has contributed an amount equal to or more than the disability benefits. This provision does not prevent an employer from making any voluntary contributions in addition to the disability benefits.

Sec. 206 provides for non-duplication of benefits under this law and other

laws; for example, title 2 of the social security act, or under an annuity or pension policy of an employer who has contributed to the cost of such annuity or pension. Likewise, disability benefits are limited or not payable if the employee also is entitled to receive permanent disability benefits under any governmental system, except a veteran's disability program. An employee may not receive disability benefits and unemployment insurance benefits at the same time, nor benefits under the workmen's compensation law.

The first payment of benefits is due on the 14th day of disability and they are payable bi-weekly thereafter.

Contributions of Employees for Disability Benefits

Every employee is required to contribute to the cost of providing disability benefits commencing on January 1, 1950, to the extent of one-half of one percent of his wages paid on and after July 1, 1950, but not in excess of 30¢ per week. To build up the special fund referred to later, employers will pay into the fund 1/10 of 1% of wages paid, but not in excess of 6¢ per week for each employee, with a like contribution from the employee, for the period from January 1, 1950, to June 30, 1950, at which time the regular contributions come into effect.

The employer is authorized to collect this contribution through payroll deductions. The employer must keep the employee contributions as a trust fund, or pay them to the State Insurance Fund or any other insurance company through whom the employer is providing for the disability benefits.

The covered employer is required to contribute the cost of providing disability benefits in excess of employees' contributions on and after January 1, 1950. This he may do in one of several ways. He may insure the payment of benefits with the State Fund. He may insure the payment of benefits with any insurance company authorized to transact accident and health insurance business in New York. He may act as a self-insurer by depositing securities of the type acceptable under Sec. 235, subd. 7, of the Banking Law, or filing a surety company bond in an amount not less than ½ of the estimated employee contributions for the ensuing year. If such amount exceeds $50,000, the securities or bond may not be less than that amount.

Any plan in existence on April 13, 1949, that now provides for the payment of disability benefits may be used by the employer, or the employer may satisfy his obligation to contribute to the payment of disability benefits by a new plan or agreement which must cover all employees.

Any employer not required to provide for disability payments may voluntarily become a covered employer and employees not covered under the law may voluntarily be brought within its provisions. By acquiring the trade or business of a covered employer, an employer becomes subject to the law.

If a covered employer does not comply with the Disability Benefits Law he becomes directly liable under this section to each of his employees for the payment of benefits. Such benefits are paid out of a special fund created under the law and the employer is forthwith required to pay the sum so expended or one-half of his payroll for his employees during the period of non-compliance. He is also subject to penalties for noncompliance.

Creation of Special Fund

A special fund for disability benefits is created through an assessment of two-tenths of one per cent of wages paid during the period from January 1, 1950, to June 30, 1950, but not exceeding 12¢ per week as to each employee. The employee himself will contribute one-half of the assessment and the employer the other half. The employee contributions are deductible from his wages.

The contributions for the first quarter of 1950 are payable by April 30 and for the second quarter are payable by July 31, 1950.

This assessment may or may not be recurrent. Each year the chairman of the Workmen's Compensation Board is required to look into the condition of this special fund. If the fund is less than 11 million dollars or less than twice the sum of benefits paid during the preceding fiscal year, whichever amount is greater, the Chairman shall assess and collect from all insurance carriers an amount sufficient to restore the fund to 12 million or twice the sum of benefits paid during the preceding fiscal year, if that sum is more than 12 million.

There is also provision in this section for a special emergency assessment if the net assets of the fund drop below 3 million dollars.

Notice and Proof of Claim

Written notice of disability must be furnished to the employer within fifteen days after commencement of the disability. If disability occurs while the employee is unemployed, the notice is furnished to the Chairman of the Workmen's Compensation Board. Thereafter if the disability continues the employer, carrier or chairman may require proof of continued disability not oftener than once a week. The employee may also be required to submit to examination by a physician designated by the employer or carrier or chairman without cost to the employee.

Any agreement by an employee to waive his rights to disability benefits is void. Neither may such benefits be assigned or released. They are also exempt from all claims of creditors or from levy, execution and attachment and these exemptions likewise may not be waived.

The Chairman of the Workmen's Compensation Board has the power to enter a judgment against an employer to enforce the payment of benefits.

Penalties

An employer who fails to make provision for payment of disability benefits is guilty of a misdemeanor and may be punishable by a fine up to $250, or imprisonment for not more than one year, or both.

In addition the chairman may impose upon the employer a penalty of ½ of 1% of the weekly payroll for the period of his failure to make provision for the payment of disability benefits plus a penalty up to $250. This penalty is payable to the special fund.

Any person wilfully making a false statement or representation or failing to disclose a material fact for the purpose of obtaining any benefit or for the purpose of influencing any determination is guilty of a misdemeanor.

A carrier that fails to make prompt payment of disability benefits without just cause may be subject to a penalty of not more than 25% of the amount of the benefits involved to be paid into the special fund. In addition the chairman may collect for the employee $3 for each week for which benefits were not promptly paid.

The employee who seeks to obtain a disability benefit and who knowingly makes a false statement with regard to a material fact is not entitled to receive benefits with respect to the particular disability, and in addition is barred from receiving any disability benefits for a period of twelve calendar months thereafter.

An attorney may represent an employee, but his fee must be approved by the board. Any other person who exacts a fee for any services rendered except in an amount determined by the board is guilty of a misdemeanor. It is likewise unlawful for any one to solicit business to appear before the board for an employee or to solicit business for a lawyer.

The law requires that certain provisions be incorporated in any policy of insurance providing for disability bene-

(Continued on page 641)

BOOK REVIEWS

Management Planning and Control

By Billy E. Goetz. McGRAW-HILL BOOK COMPANY, New York, N. Y., 1949. Pages: x + 294; $3.75.

The author, Professor of Business Administration at Antioch College and formerly senior associate of an engineering company, seems to have set his feet squarely on the ground with hands akimbo and is ready to take on all comers on his accounting views.

With the subtitle of the book, "A Managerial Approach to Industrial Accounting," the author states in the preface, "This book is an attempt to tell managements and accountants how accounting, and especially cost accounting, should be changed so as to produce data of greater value to management." While it is true the author proceeds to fulfill that promise, this reviewer feels that many "managements and accountants" would take serious exception to some of the suggestions.

For example, speaking of cost records as a basis for management, the author remarks, "Because it is misconceived, is misdirected, and attempts the impossible, traditional cost accounting is at once overelaborate, inadequate, and misleading." This reviewer wonders how many members of the National Association of Cost Accountants would agree with that statement. If the statement is true, then many of our leading universities and colleges are guilty of perpetuating this serious error in their courses in Cost Accounting.

Granted that accounting records and accounting in general are tools of management and that it is desirable to keep these tools well sharpened, this does not make it necessary to change completely the substance of the tools. Certainly accounting reports should be made intelligible to all groups using the reports. This does not necessitate washing out the foundations of the reports. The author, it seems, would have one so believe.

The book could be considered a welcome one insofar as it might tend to jolt traditional accounting thinking and concepts into seeking additional improvements in methods, procedures and applications. Most managements and accountants will agree that the pinnacle of perfection has not been reached in these directions, as yet.

The book is divided into twelve chapters. In addition, there is a Bibliography, Name Index, and Subject Index. The author has done an excellent research job not only in accounting but in fields vitally affecting accounting accomplishments, such as economics, organization, marketing, research, administration, purchasing, production, personnel, financial management, planning and control.

Throughout the book there is an air of a philosophical approach to the problem. This does not mean it is not amply sprinkled with so-called practical illustrations. There are several illustrations of forms, charts, etc., for practical applications. Perhaps it should be said the approach is one, more representing the economist rather than the accountant; these groups naturally should be in apposition, not opposition, with each other.

This book should be of challenging interest to graduate students of schools of business, particularly those interested in management engineering, cost engineering, industrial engineering, etc. Also, it should arouse sufficient interest among management staffs, professional accounting staffs, and others dealing with the problem of industrial accounting as it affects management's decisions. This reviewer does not believe it will seriously affect the position of the traditional textbooks in cost accounting.

It occurs to this reviewer that the text material might produce some very stimulating discussions in forum groups of various chapters of the National Association of Cost Accountants and the Society for the Advancement of Management. If nothing else, the book deserves to be read to learn more about whether industrial accounting is meeting its obligation to management and management is fully utilizing the products of industrial accounting.

SAMUEL RANHAND

The School of Business and
Civic Administration
The City College of New York

OFFICIAL DECISIONS *and* RELEASES

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C.

ACCOUNTING SERIES RELEASE NO. 68

Findings and Opinion of the Commission in the Matter of Proceedings under Rule II(e) of the Rules of Practice to determine whether the privilege of F. G. Masquelette & Co. and J. E. Cassell to practice as accountants before the Securities and Exchange Commission should be denied, temporarily or permanently.

ACCOUNTING—PRACTICE AND PROCEDURE
Temporary Disqualification of Accountants from Practice before Commission

Where firm of certified public accountants and partner thereof, respondents in a proceeding under Rule II (e) of Commission's Rules of Practice, certified that financial statements forming part of a registration statement filed under the Securities Act of 1933 conformed with generally accepted accounting principles when in fact they did not, and represented themselves as independent certified public accountants when in fact they were not independent, *held,* that respondents engaged in improper professional conduct and should be temporarily denied the privilege of practicing before the Commission.

APPEARANCES:

William W. Stickney, for the Office of the Chief Accountant of the Commission.

Edgar J. Goodrich, James M. Carlisle, Jerome J. Dick and *Simms, Modrall, Seymour & Simms,* for Respondents.

Joseph G. Bennis, for Respondent F. G. Masquelette & Co.

Martin A. Threet, for Respondent J. E. Cassel.

Findings and Opinion of the Commission

This proceeding was instituted under Rule II (e) of our Rules of Practice to determine whether F. G. Masquelette & Co., a firm of certified public accountants, and J. E. Cassel, a member of that firm, possess the requisite qualifications to represent others, or are lacking in character or integrity, or have engaged in unethical or improper professional conduct. If we find either of them to be deficient in any of these respects or to have engaged in improper conduct, we must then determine whether the privilege of appearing or practicing before us should be denied, temporarily or permanently.[1]

Hearings were held before a hearing examiner, who has filed a recommended decision. Counsel for the Office of the Chief Accountant of the Commission and counsel for the respondents have filed briefs and we have heard oral argument. On the basis of an independent examination of the record, we make the following findings.

When the events with which we are here concerned occurred, the firm of F. G. Masquelette & Co. had offices in Houston and El Paso, Texas, and Albuquerque, New Mexico. Cassel was the resident partner in charge of the Albuquerque office.[2]

This proceeding relates to the activities of respondents in connection with the filing of a registration statement under the Securities Act of 1933 ("the Act") by Health Institute, Inc., covering 50,000 shares of preferred stock and 40,000 shares of common stock to be sold to the public for a total of $907,500. This corporation was organized for the purpose of erecting a seven story resort hotel at Hot Springs, New Mexico, a town with an estimated population of 4,700 in the southern part of the state. The registration statement, which was filed on December 16, 1946, contained a balance sheet certified by F. G. Masquelette & Co. An amendment was filed January 13, 1947, containing an amended balance sheet,

[1] Rule II (e) reads as follows:
"The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after hearing in the matter
"(1) not to possess the requisite qualifications to represent others; or
"(2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct."
Practicing before the Commission is defined by Rule II (g) as including "the preparation of any statement, opinion or other paper by any attorney, accountant, engineer or other expert, filed with the Commission in any registration statement, application, report or other document with the consent of such attorney, accountant, engineer or other expert."

[2] At the opening of the hearings respondents moved to dismiss the proceedings or, in the alternative, that the order for proceedings be made more definite, alleging that there were in fact three firms named F. G. Masquelette & Co., one at Houston, one at El Paso and one at Albuquerque. Some persons are said to be members of all three firms, some of two and some of only one. The record is clear that F. G. Masquelette & Co. has in many ways represented itself to the public as a single firm. The hearing examiner has recommended denial of the motion and, as pointed out in respondents' briefs, no exception has been taken to this recommendation. The motion is denied.

dated January 1, 1947, also certified by F. G. Masquelette & Co. The firm name was affixed to the certificates on these balance sheets by Cassel.

An investigation was conducted under Section 8 (e) of the Act, following which the registration statement was withdrawn.

The allegations contained in the order for hearing are, generally, that respondents represented themselves as independent certified public accountants when they were not in fact independent, and that they certified that the balance sheets fairly presented the position of the company in conformity with generally accepted accounting principles when in fact generally accepted accounting principles were not applied.

The record in this proceeding includes the registration statement as originally filed together with the amendment, including exhibits, exhibits introduced in the Section 8(e) proceedings, and several affidavits submitted on behalf of respondents. Only a small amount of testimony was taken in this proceeding, and the rather extensive testimony which was taken in the Section 8 (e) proceeding was not introduced.

Cassel admitted the allegations contained in the order for hearing subject only to their explanation.

The registration statement as originally filed contained the following balance sheet and certificate:

HEALTH INSTITUTE, INC., (N. S. L.)
(Incorporated in New Mexico)

BALANCE SHEET—November 20, 1946

ASSETS	
Leasehold	$100,000.00
Construction Work in Progress	7,417.24
Organization Expense	5,178.15
Total	$112,595.39
LIABILITIES	
CURRENT LIABILITIES:	
Due on Architect's Contract, Burwinkle & Springman	$ 2,000.00
Account Payable to Charles J. Van Ruska	10,595.39
Total Liabilities	$ 12,595.39
CAPITAL STOCK:	
PRIOR PREFERRED 5½% CUMULATIVE (authorized, 50,000 shares—Par value $10.00 per share—none issued).	
Common (authorized, 50,000 shares—Par value $10.00 per share—issued and outstanding, 10,000 shares)	100,000.00
Total	$112,595.39

NOTE TO BALANCE SHEET:

Additional liabilities for organization expenses and construction work in progress (not yet capitalized) have been incurred in undetermined amounts, believed not to exceed $5,000.00 at November 20, 1946, for services of accountants, architects, attorneys, and engineers.

HEALTH INSTITUTE, INC.
Hot Springs, New Mexico

GENTLEMEN:

We have examined the Balance Sheet of Health Institute, Inc. (N.S.L.) as at November 20, 1946, have reviewed the accounting system, and procedures of the company, and have made a detailed audit of the transactions. We examined or tested accounting records and other supporting evidence to the extent and in the manner we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary. All transactions to date have been of a capital nature; no income has accrued, and no expenses have been incurred of other than a capital nature. The corporation has had no receipts, and no disbursements have been made.

In our opinion, the accompanying Balance Sheet presents fairly the position of HEALTH INSTITUTE, INC. (N.S.L.) at November 20, 1946, in conformity with application of generally accepted accounting principles.

F. G. Masquelette & Co.
CERTIFIED PUBLIC ACCOUNTANTS
Albuquerque, New Mexico
November 25, 1946.

(1) It was alleged in the order for hearing and Cassel admitted that the amount, $100,000, shown in the balance sheet for the item Leasehold was improper, and that the amount shown, $100,000, in respect of the item Capital Stock, Common, was likewise improper without deducting the discount resulting from its issuance for a nominal consideration.

The leasehold in question was a 99-year lease, dated July 15, 1946, covering approximately 96/100ths of an acre in Hot Springs. It ran to Charles J. Van Ruska, president and principal promoter of Health Institute, Inc., as lessee, and was assigned by him to the company on November 16, 1946, in exchange for 9,998 shares of common stock. The lease provided for a monthly rental of $150 a month for the first three months, $300 a month thereafter until June 15, 1971, and $150 a month from that date until the end of the term. Among other things, the lease required the lessee to pay all taxes and to move the existing houses on the property to other property owned by the lessors.

The circumstances under which Van Ruska entered into this lease are not shown by the record in this proceeding. It is clear, however, that there is no justification for its appearing in the balance sheet at a figure of $100,000. The deed conveying the property to the lessors is dated April 30, 1945, and recites a consideration of $15,000. The property was assessed for the year 1946 at $5,250, of which $3,000 was allocated to improvements. The expenses of Van Ruska in connection with the lease were nominal. Notwithstanding his full knowledge of these facts, Cassel, on behalf of F. G. Masquelette & Co., certified falsely that the balance sheet, on which the leasehold was shown at $100,000, conformed to generally accepted accounting principles.

In the second balance sheet,[3] contained in the amendment to the registration statement, the following note was appended to the item "Leasehold . . . $100,000.00":

"(1) Valuation of leasehold is purely arbitrary, and is placed at a figure to equal the par value of the COMMON stock issued in exchange for the leasehold. The direct cost of the above lease to Charles Joseph Van Ruska, personally, and the assignment of the same to Health Institute, Inc. (N. S. L.) exceeded $2,000. In addition, Mr. Van Ruska has spent an excess of $10,000 of his personal funds in the promotion of this enterprise. Neither of these costs (out-of-pocket expenses) are being borne by the Corporation. In addition to these out-of-pocket expenses, Mr. Van Ruska has spent his time and effort and experience over a period of approximately six months in the promotion of this enterprise with no cost to the Corporation."

The addition of this footnote did not cure the deficiency. Dealing with a similar situation, we said in *Queensboro Gold Mines, Ltd.*, 2 S. E. C. 860 (1937), at page 862:

"Nor is the mischief fully cured by an explanatory note revealing that the figure is 'purely arbitrary' and that the vendor, who purchased the property 'at a nominal cost' to himself, 'controlled the board who valued' the property . . . Such disclosure, while helpful, is not sufficient."

And in *Mining and Development Corporation*, 1 S. E. C. 786 (1936), at page 799 we said:

"Moreover, even were the footnote to state with complete frankness the true fact that the assets were over-valued, this would not mitigate the effect of the valuation figure itself. A balance sheet item which is flatly untrue will not be rendered true merely by admission of untruth."

As stated above, it was charged that the amount, $100,000, shown in the balance sheet with respect to the item Capital Stock, Common, was improper in that the discount resulting from the issuance of the stock for a nominal consideration was not deducted. As the stock was issued for the leasehold, which, it is admitted, was improperly shown on the balance sheet at $100,000, it follows that it was improper to indicate that the stock had been issued at its full par value, whereas, in fact, it had been issued at a discount.[4]

(2) It was alleged in the order for hearing and admitted by Cassel that the balance sheet as at November 20, 1946, improperly included the items "Construction Work in Progress—$7,417.24," "Organization Expense—$5,178.15" and "Account Payable to Charles J. Van Ruska—$10,595.39."

The amount of $7,417.24 shown for "Construction Work in Progress" included $2,000, liability for which was shown in the balance sheet under the caption "Due on Architect's Contract, Burwinkle & Springman." The remainder, $5,417.24, of the item "Construction Work in Progress" and the amount of $5,178.15 shown as "Organization Expense" constituted the alleged liability of $10,595.39 to Van Ruska.

Admittedly, Cassel did not take adequate steps to verify the accuracy of these items. As stated above, Van Ruska was president and principal promoter of Health Institute, Inc. Cassel's work-papers indicated supporting vouchers for only $2,363.89 ($1,301.49 classified as Construction Work in Progress and $1,062.40 as Organization Expense) of the expenditures claimed to have been made by Van Ruska, and Cassel made no independent investigation as to whether Van Ruska had paid, or was obligated to pay, or whether Health Institute, Inc. was properly chargeable with, the $8,231.50 balance allegedly due Van Ruska. He relied entirely on a written statement by Van Ruska that the company owed him that amount. Cassel's work sheets show that he participated with Van Ruska in drafting this statement, which was later typed and signed by Van Ruska.

Such procedure does not constitute an adequate verification of accounts by an independent accountant and the statement in the certificate of F. G. Masquelette & Co., affixed to the balance sheet of Health Institute, Inc., as at November 20, 1946, that their "examination was made in accordance with gener-

[3] The accountants' certificate appended to this balance sheet is identical with the one filed with the earlier balance sheet, which is quoted above, except that the date January 1, 1947, is substituted for November 20, 1946.

[4] The impropriety here results from the use of the once very common, but now thoroughly discredited, device of employing par value as a representation of value for financial statement purposes. This practice developed from a widespread misconception of the meaning and significance of par value. See Hatfield, *Accounting*, 1927, pp. 72, 196–209; also Newlove, Smith and White, *Intermediate Accounting*, 1939, pp. 239–240; and May, *Financial Accounting*, 1943, p. 109.

ally accepted auditing standards applicable in the circumstances" was manifestly false.[5]

Van Ruska later disclaimed the purported indebtedness and admitted that he had not made expenditures in the amounts shown. These items were omitted from the second balance sheet.

(3) It was alleged in the order for hearing and Cassel admitted that the certificates affixed to the balance sheets as at November 20, 1946, and January 1, 1947, falsely stated that such balance sheets fairly presented the financial position of Health Institute, Inc., at the respective dates.

It is clear that the inclusion in both balance sheets of the amount of $100,000 in respect of the leasehold, and of a similar amount for Capital Stock, Common, and the inclusion in the balance sheet as of November 20, 1946, of the amounts of $7,417.24, $5,178.15 and $10,595.39 for Construction Work in Progress, Organization Expense, and Account Payable to Charles J. Van Ruska, respectively, contravened generally accepted accounting principles. The balance sheets, therefore, did not fairly present the financial position of the company.

(4) It was alleged in the order for hearing and Cassel admitted that the certificates affixed to the two balance sheets contained false statements that the accountants had (a) reviewed the accounting system and procedures of the company, (b) made a detailed audit of the transactions, (c) examined or tested accounting records and other supporting evidence, and (d) made an examination in accordance with generally accepted auditing standards applicable in the circumstances.

The record indicates, and it was admitted, that the company had no books of account and no accounting system, and had no accounting records other than a few vouchers and rough notes in Cassel's own files. In these circumstances the statements in the certificates concerning the scope of the accountant's examination and the statement that such examination was made in accordance with generally accepted auditing standards applicable in the circumstances were patently false and misleading.[6]

(5) It was alleged in the order for hearing and Cassel admitted that while respondents were purporting to certify the financial statements as independent certified public accountants, Cassel actively participated in the promotion of Health Institute, Inc.

Cassel was introduced to Van Ruska on or about July 18, 1946. From that time until the hotel enterprise was abandoned he worked closely with Van Ruska and his associates in an effort to further the project. In particular, he corresponded with three underwriting firms and an insurance company in an effort to obtain financing for the enterprise. He participated in discussions with the local office of the Civilian Production Administration, and assisted in preparing an application for a permit to proceed with the construction of the hotel. He arranged for the publication of newspaper articles publicizing the proposed hotel. He drafted the agenda for at least one directors' meeting, and was present at a number of meetings. He negotiated with the architects and arranged an architects' agreement. He solicited the purchase of shares of stock of the company. In short, Cassel participated actively in many things that were done in the promotion of the hotel.

Respondents argue that Cassel was not in reality a promoter and that his activities amounted to nothing more than "running errands" for Van Ruska. It is pointed out that Cassel's office was in Albuquerque, while Van Ruska's headquarters were in Hot Springs. It is urged that if Van Ruska had something to be done in Albuquerque it was only natural for him to ask Cassel to do it and for Cassel to help him out. Van Ruska had no office facilities, and Cassel permitted Van Ruska to use his office, and on occasion wrote letters on Van Ruska's behalf. While, possibly, some of Cassel's activities might properly be characterized as "errands," we find it extremely difficult to conclude that a certified public accountant so intimately identified with the accounting profession as Cassel[7] would permit himself to be used as a mere runner of errands. Certainly such activities are incompatible with the practice of public accounting by an independent accountant. Moreover, Cassel rendered active assistance in attempting to organize the enterprise, suggesting procedures to be followed and persons to be consulted about various aspects of the matter, and in attending to a large part of the work himself.

We find that Cassel was a promoter of Health Institute, Inc.[8] A finding of his lack of independence follows from Rule 2-01 (b) of Regulation S-X, which reads as follows:

"The Commission will not recognize any certified public accountant or public ac-

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[5] See *National Boston Montana Mines Corporation*, 2 S. E. C. 226, 249 (1937); *Associated Gas and Electric Company*, 11 S. E. C. 975, 1054 (1942); *In the Matter of Drayer-Hanson, Incorporated*,—S. E. C.—, Securities Act Release No. 3277, Accounting Series Release No. 64 (1948).

[6] See Accounting Series Release No. 13 (1940).

[7] At the date of these proceedings Cassel was a director and a past president of the New Mexico Society of Certified Public Accountants; he was also a member of the committee on membership and a former Council member of the American Institute of Accountants.

[8] "The term 'promoter' includes—

"(a) Any person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer." Rule 405, General Rules and Regulations under the Securities Act of 1933 (formerly Rule 455).

countant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee."

Respondents point out that at the time Cassel engaged in these various activities there was no thought of registering under the Securities Act and that it was hoped that the enterprise could be financed in large part by private loans. For instance, at the time Cassel carried on negotiations with various underwriting firms and an insurance company it was thought that no public offering of securities would be necessary. This argument is, of course, quite beside the point. Cassel is not criticized for acting as a promoter. The impropriety charged, and here sustained, is that he purported to certify to the financial statements as an independent accountant after he had become so enmeshed in the promotion of the enterprise that he could no longer have properly considered himself independent.

We have found, among other things, that Cassel certified the balance sheets of Health Institute, Inc., as an independent accountant, when he was not in fact independent; that the certificates included the statement that his examination was made in accordance with generally accepted auditing standards applicable in the circumstances, when it was not; and that the certificates contained the statements that the balance sheets conformed to generally accepted accounting principles and fairly presented the financial position of the company, when such was not the case. In short, we have found that the balance sheets, and Cassel's representations with respect thereto were completely false and misleading. Under these circumstances we find that Cassel engaged in improper professional conduct within the meaning of Rule II (e).

We turn to the firm of F. G. Masquelette & Co. As stated above, Cassel was the resident partner of the firm in Albuquerque. He made such examination as was made of the accounting transactions of Health Institute, Inc., and signed the certificates applicable to the balance sheets of the company as at November 20, 1946 and January 1, 1947 in the name of F. G. Masquelette & Co. There is no indication in the record, nor does the record show any contention on the part of F. G. Masquelette & Co., that Cassel was not authorized to sign, or that he exceeded his authority in signing, the certificates in the firm's name.

In a recent case we held that "where a firm of public accountants permits a report or certificate to be executed in its name the Commission will hold such firm fully accountable."[9] We find that, by reason of Cassel's activities, the firm of F. G. Masquelette & Co. engaged in improper professional conduct within the meaning of Rule II (e).

Having found that Cassel and F. G. Masquelette & Co. engaged in improper professional conduct within the meaning of Rule II (e), we must determine whether the privilege of practicing before us should be denied them, temporarily or permanently.

Under all the circumstances, considering the nature of the improprieties practiced by Cassel and the extent of the firm's responsibility therefor we think the public interest is appropriately served by denying F. G. Masquelette & Co. the privilege of practicing before this Commission for a period of 30 days from the date of the issuance of our order, and denying J. E. Cassel the privilege of practicing before this Commission for a period of one year from the date of the issuance of our order.

An appropriate order will issue.

By the Commission (Chairman Hanrahan and Commissioners McEntire, McDonald, and Rowen).

Orval L. DuBois,
Secretary.

[9] See Accounting Series Release No. 67 (April 18, 1949).

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